

and public companies.¹⁹⁹ While this divergence between the UK and U.S. and continental Europe may be due in part to differences in ownership structure, and in part to the fact that mergers are more common on the continent than in the UK (where business planners favor tender offers²⁰⁰), it surely also reflects a more basic difference in the permitted transactional flexibility as well as views on the relative value of judicially-enforced standards on the one hand, and *ex ante* rules and decision rights on the other.²⁰¹

Finally, the protection of non-shareholder constituencies in significant corporate actions resembles that offered by corporate governance more generally. As compared with U.S. law, EC and Japanese law are more protective of creditors, both in general (through capital maintenance rules) and when firms embark on mergers and other organic changes. Moreover, not surprisingly, EC law provides workers with substantially more protection in mergers and other restructurings than U.S. law does.

¹⁹⁹ See Company Law Review Steering Group, *Modern Company Law. For a Competitive Economy, Final Report* 1281 (2001) (a majority of consultees thought it would be inappropriate to create a broader statutory merger procedure without court supervision for private companies).

²⁰⁰ Of course, the absence of more general merger provisions may also have led to a preference for tender offers in the UK.

²⁰¹ Unsurprisingly, academics also debate the benefits and determinants of Mergers & Acquisitions (M&A) activity. See, e.g., Geger Andrade, Mark Mitchell, and Erik Stafford, *New Evidence and Perspective on Mergers*, 15(2) JOURNAL OF ECONOMIC PERSPECTIVES 103 (2001); Marina Marynova and Sjoerd Oosting, *The Long-Term Operating Performance of European Mergers and Acquisitions*, in *International Mergers and Acquisitions: Activity since 1990: Recent Research and Quantitative Analysis* (G. Gregorion and L. Renneboog (eds.), 2007), at 79–116.

Control Transactions

Paul Davies and Klaus Hopt

8.1 Agency Problems in Control Transactions

8.1.1 Control transactions

In this chapter we consider the legal strategies for addressing the principal/agent problems which arise when a person (the acquirer) attempts, through offers to the company's shareholders, to acquire sufficient voting shares in a company to give it control of that company.¹ The core transaction in this chapter is one between a third party (the acquirer)² and the company's shareholders,³ whereby the third party aims to acquire the target company's shares to the point where it can appoint its nominees to the board of that company. This is what we mean in this chapter by 'control transactions'. Of course, control may also pass to a new shareholder or set of shareholders as a result of transactions between *the company* and its shareholders or the investing public (as when a company issues or re-purchases shares). However, such control transactions involving corporate decisions can be analysed in the same manner as other corporate decisions, a task we undertake elsewhere in this book. The absence of a corporate decision and the presence of a new actor, in the shape of the acquirer, give the agency problems of control transactions (as defined) a special character which warrants separate treatment in this chapter.⁴

¹ Note that we will use the terms 'company' and 'corporation' interchangeably.

² Of course, the acquirer may, and typically will, already be a shareholder of the target company, but it need not be and the relevant rules (other than shareholding disclosure rules) do not turn on whether it is or not. The bidder may also be or contain the existing management of the target company (as in a management buy-out (MBO)). This situation generates significant agency problems for the shareholders of the target company which we address below.

³ More precisely, its vote-holders. As we see below, addressing effectively both the main sets of agency problems in this area is made more problematic where voting rights and cash-flow rights in a company are not proportionately distributed.

⁴ The special character of control transactions is also reflected in the increasing number of jurisdictions which have adopted sets of rules, separate from their general company laws, to regulate them.

More challenging for analysis is the distinction between shifts in control through statutory mergers⁵ and control transactions. In terms of end result, there may not be much difference between a statutory merger and a friendly takeover bid, at least where the successful bidder avails itself of a mechanism for the compulsory purchase of non-accepting minorities. However, in terms of the legal techniques used to effect the control shift, there is a chasm between the two mechanisms. A merger involves corporate decisions, certainly by the shareholders and usually by the board as well. Control transactions, by contrast, are effected by private contract between the acquirer and the shareholders individually. Nevertheless, at least in friendly acquisitions, the acquirer often has a free choice whether to structure its bid as a contractual offer or as a merger proposal. This creates a regulatory dilemma. In some jurisdictions the regulation of takeovers is confined to control shifts, as defined above.⁶ Others, the minority, adapt the rules for control shifts and apply them, at least in part, to acquisitions through statutory mergers, on the grounds that many of the principles applicable to contractual offers (for example, the equality rules governing the level of the required consideration, some of the timing rules and even the 'no frustration' principle) can be applied to control shifts by means of statutory mergers. Moreover, not to do so might provide an incentive for acquirers to structure their offers that way. Where this latter approach is adopted, the rules on control transactions act as an additional layer of regulation of the statutory merger, whose significance depends upon the extent to which the rules for statutory mergers have not already occupied the regulatory ground.⁷

Control transactions, not implemented as statutory mergers, may be effected in a variety of ways which can be used singly or, more likely, in combination: via private treaty with a small number of important shareholders, via purchases of shares on the market; or by way of a general and public offer to all the shareholders of the target company. In the case of the public offer it may be either 'friendly'

⁵ See *supra* 7.4.

⁶ Thus, the definition of a takeover in Art. 2.1(a) of the Directive of the European Parliament and of the Council on takeover bids (2004/25/EC, O.J. L 142, 30.4.2004—hereafter 'Takeover Directive') excludes statutory mergers.

⁷ Thus, in the UK, the City Code starts from the principle that the Code applies equally to the peculiar UK version of the statutory merger (the 'scheme of arrangement'; see *supra* 7.4), except to the extent that the statutory merger procedure regulates a particular issue or the nature of the statutory merger procedure makes a particular Code provision inapplicable. (The Panel on Takeovers and Mergers, THE TAKEOVER CODE (9th ed., 2009) § A3(b) and Appendix 7—hereafter 'City Code'). This recently introduced Appendix results from the Panel's decision further to specify how the Code applies to mergers in the light of the significant increase in recent years in the use of schemes of arrangement in order to implement transactions which are regulated by the Code; see Panel Consultation Paper 2007/1. By contrast, the acquisition of Bank Austria AG by Bayerische Hypo Vereinsbank was effected by a merger in order to avoid the new Austrian takeover legislation. See 4 NEUE ZEITSCHRIFT FÜR GEMEINSCHAFTSRECHT 282 (2001).

(i.e., supported by the management of the target company) or 'hostile' (i.e., made over the heads of target management to the shareholders of the target).⁸

Of the three acquisition methods, the second and third are clearly facilitated if the target's shares are traded on a public market. For this reason, companies with publicly traded shares are at the centre of attention in this chapter. In fact, legislation specific to control transactions is usually (though not always) confined to companies whose securities are traded on public markets (or some sub-set of these, such as the top-tier markets).⁹ Not only are hostile bids difficult to organize other than in relation to publicly traded companies, but also the shareholders' agency and coordination problems (discussed below) are less pronounced in closely held companies. Nevertheless, the control transaction is not logically confined to such companies and we make some reference to non-traded¹⁰ companies as well. In jurisdictions which rely on general corporate standards, such as fiduciary duties, rather than rules specific to control transactions, to regulate the behavior of target management or the target's controlling shareholders, the application of these standards to the managements and shareholders of non-traded companies raises no difficult boundary questions.¹¹

8.1.2 Agency and coordination issues

8.1.2.1 Where there are no controlling shareholders in the target company

Where there are no controlling shareholders in the target company, the main focus is on the first agency relationship, i.e., that between the board and the shareholders as a class. Here, the acquirer's underlying strategy is likely to focus on a public offer to all the shareholders, preceded by pre-bid acquisition, through the market, of as large a 'toehold' shareholding in the target as the acquirer can manage without revealing the object of its intended offer. Unlike in the case of the

⁸ Of course, the board's decision whether to recommend an offer, either at the outset or during the course of an initially hostile offer, will often be influenced by its estimate of the bidder's chances of succeeding with a hostile offer. Further, the number of concluded deals which remain hostile to the end is likely to be small whether or not the incumbent management is in a position effectively to block the bid: if it can, the acquirer will negotiate with it to achieve its recommendation; if it cannot, there is little point in target management opposition. Thus, it may be difficult to characterize a particular bid as 'friendly' or 'hostile' but the question of whether a particular system of rules facilitates hostile bids is of enormous importance. See *infra* 8.2.1.

⁹ Thus the Takeover Directive applies only to companies whose securities are traded on a 'regulated market' (Art. 1.1)—normally a top-tier market. The City Code applies slightly more widely to all companies which may offer their shares to the public and even to closely held companies (where there has been something analogous to a public market in the private company's shares) (City Code, § A3(a)).

¹⁰ Throughout this book, corporations whose shares do not trade freely in impersonal markets are also referred to as 'closely held' companies.

¹¹ See *infra* 8.3.1 for a discussion of U.S. rules on sales of shares by controlling shareholders to looters.

company with controlling shareholders, the control shift effected by a successful general offer in this case is not from those who have control (the blockholders) to the acquirer who wishes to obtain it. Rather, *de facto* control of the company was probably in the hands of the target board, so that control shifts from the board of the target to the (board of the) acquirer. Therefore, there is a disjunction between the parties to the dealings which bring about the transfer of control (acquirer and target shareholders) and the parties to the control shift itself (acquirer and target board).

It is precisely this disjunction which generates the agency issues which need to be addressed. The control transaction may be wealth-enhancing from the target shareholders' point of view but threaten the jobs and perquisites of the existing senior management. The incumbent management of the target may thus have an incentive to block such transfers, by exercising their powers of central management. They may seek to use those powers to make the target less attractive to a potential bidder or to prevent the offer being put to the shareholders. These steps may take a myriad of forms but the main categories are: placing a block of the target's securities in the hands of persons not likely to accept a hostile bid; structuring the rights of the shareholders and creditors, for example, through poison pills; and placing strategic assets outside the reach of even a successful bidder.

Alternatively, the transaction may not be wealth-enhancing from the shareholders' point of view but the incumbent management may have an incentive to promote it to the shareholders, because the management stand to gain from the proposed control shift, either by reaping significant compensation for loss of office or by being part of the bidding consortium. The control transaction cannot be effected without the consent of the shareholders, the transfer of whose securities is the central mechanism for effecting the shift. However, the incumbent management may use their influence with the shareholders and their knowledge of the company to 'sell' the offer to its addressees or, in the case of competing bids, they may use those factors to favour one bidder over another.

However, the rules governing control shifts need also to deal with a second matter where shareholdings in the target company are dispersed. This is the coordination problem of dispersed shareholders as against the acquirer. In particular, the acquirer may seek to induce shareholders of the target to accept an offer which is less than optimal. There are a number of ways in which this can be done,¹² but in essence they rely on information asymmetry or unequal treatment of the target's shareholders. Moreover, the agency problems of the shareholders as a class as against the incumbent management may continue even if the latter do not (or cannot) prevent an offer from being made. This is particularly likely to be the case where it is in the interests of the incumbent management to promote a deal between the acquirer and the target shareholders.

8.1.2.2 Where there are controlling shareholders¹³

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

However, the general rules of civil law are not likely to address effectively the coordination problems as between the acquirer and the non-controlling shareholders (at least if these are dispersed) nor the agency problems between controlling and non-controlling shareholders. The former problem is largely the same as that discussed in relation to companies with no controlling shareholder.¹⁴ As to the latter, the controlling shareholder may engage in rent-seeking by selling control of the company to an acquirer who will 'loot' it; or, simply sell it to an acquirer who, perhaps for good commercial reasons, will be less respectful of the interests of non-controlling shareholders than the vendor had been. This is particularly so where the target, upon acquisition, will become a member of a group of companies where business opportunities, which the target has been able to exploit in the past, may be allocated to other group members. The law could seek to address this problem by focusing on the existing controlling shareholder's decision to sell or on the terms upon which the acquirer obtains the controlling block or upon the subsequent conduct of the affairs of the target by the new controller. In the last case, reliance will be placed on the general legal strategies for controlling centralized management, including group law.¹⁵ In the first and second cases, the law is likely to develop rules or standards specific to the control transaction, though they may take a wide variety of forms, up to and including an exit right for the minority upon a change of control, via a mandatory bid requirement.¹⁶

8.1.2.3 Agency problems of non-shareholders

Finally, whatever the structure of the target company's shareholding, agency issues will arise as between the acquirer and non-shareholders, especially employees. In those countries where company law is used to address company/employee agency issues as a matter of general practice via standing employee or union representation on the board,¹⁷ a control shift effected simply by means of a transaction between the acquirer and the target shareholders, thus by-passing the corporate organ which embodies the principle of employee representation, is

¹³ All jurisdictions will face such situations, even if the typical pattern of shareholdings in com-

panies in that jurisdiction is the dispersed one.

¹⁴ *Supra* 8.1.2.1.

¹⁵ See *supra* 4.1.

¹⁶ See *infra* 8.3.

¹⁷ See *supra* 4.2.1.

likely to be regarded with suspicion. Consequently, the strategy of using board composition rules to address the general agency costs of employees will argue in favour of the insertion of the board into the control shift transaction, usually via a relatively relaxed regulation of defensive measures on the part of the target board. Even where company law is not normally used to address employee agency issues, the freedom of management to take defensive measures may be seen as a proxy for the protection of the interests of employees and, possibly, other stakeholders. As we shall see,¹⁸ the closeness of the 'fit' between the ability of management to defend itself and the interests of non-shareholder stakeholders is contentious. Beyond this, regulation of the control transaction, because of its focus on the acquirer/target shareholder relationship, is unpropitious ground for dealing with the agency costs of employees, except through disclosure of information, which may be useful to stakeholders generally in the generation of political or social pressure in response to the offer,¹⁹ or through mandatory consultation over the consequences of the takeover for the employees.

Creditors, as well as employees, may stand to lose out as a result of changes in the company's strategy implemented by the acquirer, especially changes in the company's risk profile, perhaps arising from the leveraged nature of the bid. Those most at risk, the long-term lenders, are well placed to protect themselves by contractual provisions, such as 'event risk' covenants in loans.²⁰ Such protections may not always be fully protective of the creditors, but adopting sub-optimal contractual protection is normally part of the commercial bargain contained in the contract. Consequently, the agency costs of creditors are not normally addressed in control-shift rules.²¹

8.1.2.4 *The nature and scope of control-shift regulation*

Many of the agency problems of control transactions are familiar from earlier chapters of this book. However, they appear in this chapter in a novel context. A central feature of that context is the tension between a commitment to the free transferability of shares and a recognition that sales of shares sufficient to produce a control shift have consequences for the policies of the company which would normally call for a decision of either the board or the general meeting (or, of course, both). This point applies as much to transfers from existing controlling shareholders as to transfers of control from the board of the target. Moreover, the control transaction brings onto the scene a new actor, namely the acquirer, whose

¹⁸ *Infra* 8.5.

¹⁹ Trade unions and management in some countries may be able to form an effective, if implicit, coalition to oppose a proposed acquisition.

²⁰ William W. Bratton, *Bond Covenants and Creditor Protection*, 7 EUROPEAN BUSINESS ORGANIZATION REVIEW 39 especially at 58ff (2006).

²¹ It is sometimes difficult to distinguish covenants whose aim is to protect the lender and those which aim to protect target management (poison debt); in fact, both groups may have an interest in inserting provisions which make debt repayable upon a change of control. However, this point relates to the agency costs of the shareholders, not the creditors.

activities both generate new problems (arising, for example, out of the manner in which the offer to the shareholders of the target is formulated) and reveal the traditional agency problems (for example, that between shareholders and management of the target) in a novel and more complicated setting.

A major question which then arises is whether the element of novelty in the control transaction leads to the fashioning of rules specific to control shifts or whether the agency and coordination issues inherent in control transactions can be handled by the application of the established principles of corporate and securities law, albeit in this new context. All our jurisdictions utilize to some degree both types of approach, but the balance between them can vary considerably. Towards one end of the spectrum stands the law applicable where the target company is incorporated in Delaware. Although both federal law (in the shape of the Williams Act)²² and Delaware law (in the shape of rules governing access to the short-form, squeeze-out merger)²³ contain some rules specific to control transactions, the main weight of the rules on control shifts (for example, dealing with the allocation of decision rights over the offer)²⁴ is to be found in the application to the directors of the target company of the general fiduciary standards governing board decision-making.

By contrast, in the member states of the European Community rules specific to control shifts are more important (though not to the complete exclusion of general rules of corporate and securities law). Thus, the Takeover Directive lays down an extensive set of rules which is confined to control shifts. Further, the directive reflects the long-standing leaning towards extensive control-shift specific rules in some of the member states, notably France, Italy, and the UK. Japan sits somewhat between these two models, though it is difficult to classify as its rules are still in a state of development. It has legislation specific to control shifts,²⁵ but, on the central issue of the allocation of decision rights over the offer, court-developed general standards applying to directors' decisions are still central.²⁶

The line between a rule specific to control transactions and the application of a general corporate law principle to control shifts may be a fine one, especially if the general principle is applied frequently in the specific context and begins to form a jurisprudence of its own. Nevertheless, it is a significant one. First, the type of body responsible for the application of the rules is likely to be different. The application of the body of specific rules is likely to be a task given to a specialized agency. The Takeover Directive requires member states to 'designate the authority or authorities competent to supervise bids for the purpose of the rules which

²² 1968, 82 Stat. 454, codified at 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f), adding new §§ 13(d), 13(e), and 14(d)-(f) to the Securities Exchange Act of 1934.

²³ *Infra* 8.4.

²⁴ *Infra* 8.2.3.

²⁵ See Art. 27-2(1)(5) of the Financial Instruments and Exchange Act 2006.

²⁶ *Infra* 8.2.2—coupled in this case with non-binding guidelines issued by the government.

they make or introduce pursuant to this Directive.²⁷ This will generally be the financial markets regulator but may be a specific regulator for takeovers.²⁸ The application of general corporate law principles, by contrast, is likely to be a task which falls to the courts, so that the core of control shift regulation in Delaware is judge-made. Second, as noted,²⁹ specific control shift rules tend to apply only in respect of target companies whose shares are publicly traded, whereas general principles can be adapted by the courts for all types of control shift. Third, it has been argued that the 'judicialization of US takeover regulation made it easier for a pro-management approach to emerge' because, on the one hand, case law precedents are relatively free from interest group influence and, on the other, the courts can decide only the cases which come before them and management (and their lawyers) are in a good position to control the flow of litigation and appear as repeat players before the courts.³⁰ Of course, this does not mean that specific regulation is necessarily pro-shareholder: that depends on how interest group pressures play out in any particular case. As we shall see, a variety of patterns of specific regulation across jurisdictions can be found.

However, takeover-specific rules do not often address the agency problems which arise as between the shareholders of the *acquiring* company and their board in relation to the decision to acquire the target; and we shall follow that lead in this chapter. This issue is but an example (albeit an important one) of the general agency problems existing between shareholders (and creditors) and boards in relation to setting the corporate strategy, which have been fully analysed in earlier chapters.³¹ However, it is central to this chapter to consider the extent to which regulation purportedly designed to address the agency and coordination costs of *target* shareholders (both as a class and as non-controlling shareholders) impacts upon the incentives for potential bidders actually to put forward an offer.³²

²⁷ Art. 4.1.

²⁸ The former is by far the more common choice but the UK, for largely historical reasons, gives the supervision of takeovers to a body (City Panel on Takeovers and Mergers) different from the general financial market regulator (Financial Services Authority (FSA)).

²⁹ *Supra* 8.1.1.

³⁰ J. Armour and D. Skeel, *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergences of U.S. and U.K. Takeover Regulation*, 95 *GEORGETOWN LAW JOURNAL* 1727, 1793 (2007).

³¹ See *supra* Chapters 3 and 5.

³² On this issue in general see Athanasios Koulouridas, *THE LAW AND ECONOMICS OF TAKEOVERS: AN ACQUIRER'S PERSPECTIVE* (2008). The empirical literature is virtually unanimous in concluding that target shareholders capture nearly all of the gains from takeovers and that the gains for bidders' shareholders are small or non-existent (even negative for hostile takeovers). See M. Martynova and L. Renneboog, *MERGERS AND ACQUISITIONS IN EUROPE* (2006) 5.1 and 5.2 (available on http://www.ssrn.com/abstract_id=880379)—confirming the U.S. empirical studies in relation to the European takeover wave of 1993 to 2001. Acquirer shareholders thus seem to have strong incentives to control their management's misjudgments in this area.

8.2 Agency Problems Where There is No Controlling Shareholder

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

The central issue is the extent to which the bidder is provided with access to the target shareholders to make and maintain an offer for their shares without the consent of the incumbent management. Theoretically, the available solutions range from allocating the decision on the control shift exclusively to the shareholders by depriving the management of any role in the interactions between acquirer and target shareholders, to designing the control shift decision as a joint one for incumbent management and shareholders, as if it were a statutory merger. In the former case, the shareholders' agency problems as against the management are resolved by terminating the agency relationship for this class of decision: the principal is protected by becoming the decision-maker³³ and the principle of free transferability of shares is made paramount. In the latter case, both management and target shareholders must consent if the control shift is to occur. The acquirer is forced to negotiate with both groups. The potential gains from the control shift may now have to be split three ways (acquirer, target shareholders, target management) and, to the extent that the benefits to management of their continuing control of the target company exceed any share of the gain from the control shift which the acquirer is able or willing to allocate to them, fewer control shifts will occur.

8.2.2 The 'no frustration' rule

The choice of vesting the decision on the offer in the shareholders alone is most prominently illustrated by the UK Code on Takeovers and Mergers, which, since its inception in 1968, has contained a 'no frustration' injunction addressed to the board of the target company. This provides that 'during the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent, the board must not, without the approval of the shareholders in general meeting, take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits...'³⁴ This is an effects-based rule, not one dependent on the intentions or motives of the board. Action on the

³³ Typically, the shareholders determine the fate of the offer by deciding individually whether to accept the offer or not, but in some cases the shareholders' decision may be a collective one, as where the shareholders decide in a meeting whether to approve the taking of defensive measures by the incumbent management or where the shareholders vote to remove a board that will not redeem a poison pill. *Id.* *supra* 8.2.2 and 8.2.3.

³⁴ Rule 21.1.

part of the incumbent management which might 'frustrate' an offer an acquirer wishes to put to the target shareholders is legitimate under this rule only if the shareholders themselves, through a collective decision, have approved it, i.e., have in effect rejected the offer. The 'no frustration' rule recognizes that effectively to implement a strategy of exclusive shareholder decision-making in relation to public offers requires rules which ensure, not only that shareholders are free to accept offers which are put to them, but also that offerors are free to put offers to the shareholders. In other words, the law must provide entry rules for acquirers as well as exit rules for shareholders.

The 'no frustration' (or 'board neutrality')³⁵ rule was proposed by the European Commission as a central element in the Takeovers Directive, but it proved controversial (especially in Germany) and agreement among the member states was possible in the end only on the basis that it became a rule the member states could choose not to make mandatory in their jurisdictions.³⁶ Nevertheless, the 'no frustration' rule became widely adopted in the European Union during the long process of negotiation over the directive (though not in Germany).³⁷

It is clear in both the City Code and the directive that shareholder approval means approval given during the offer period for the specific measures proposed and not a general authorization given in advance of any particular offer. A weaker form of the shareholder approval rule is to permit shareholder authorization of defensive measures in advance of a specific offer. This is a weaker form of the rule because the choice which the shareholders are making is presented to them less sharply than under a post-bid approval rule.³⁸ On the other hand, rendering pre-bid approval of post-bid defensive measures ineffective makes it more difficult for shareholders to commit themselves to handling future offers through board negotiation with the bidder.³⁹ Pre-bid shareholder approval is one way of legitimizing defensive action in Germany⁴⁰ and also in Japan. In the latter the

³⁵ The Community-level discussion normally uses the term 'board neutrality' but we prefer the term 'no frustration' as more accurately indicating the scope of the rule. See *infra* 8.2.2.1.

³⁶ Directive 2004/25/EC, Arts. 9.2 and 12.1. Even if a member state does not impose the rule, a company must be given the right to opt into the 'no frustration' rule: Art. 12.2. The same solution was adopted in relation to the 'break-through rule': *infra* 8.3.2.

³⁷ Commission of the European Communities, *Report on the implementation of the Directive on Takeover Bids*, SEC(2007) 268, February 2007, p.6, indicating that 17 of the 25 member states had a 'no frustration' rule in place before the adoption of the directive.

³⁸ This point is well captured in the French terminology which refers to advance authorization as approval given 'à priori' and authorization given after the offer as given 'à chaud': Cf David Kershaw, *The Illusion of Importance: Reconsidering the UK's Takeover Defence Prohibition*, 56 INTERNATIONAL AND COMPARATIVE LAW QUARTERLY 267 (2007), arguing that the 'no frustration' rule of the Code adds little or nothing to UK company law, but on the basis that pre-bid and post-bid approval are functionally equivalent.

³⁹ On pre-commitment see *supra* 7.2. For the possible use of pre-bid defensive measures to this end see *infra* 8.2.3.

⁴⁰ § 33(2) *Übernahmegesetz*. Such permission may be given for periods of up to 18 months by resolutions requiring the approval of three-quarters of the shareholders, though the constitution of a particular company may set more demanding rules. However, approval may also be given post-bid by the supervisory board without shareholder approval (§ 33(1) *Übernahmegesetz*, last sentence)

governmental guidelines favor pre-bid approval of defensive action 'to allow the shareholders to make appropriate investment decisions'.⁴¹ However, court decisions are unclear whether pre-bid approval will always legitimize defensive measures.⁴² Like Germany, Japan also contemplates the legality in certain situations of defensive measures taken by the board unilaterally, and to that extent the two countries embrace the joint decision-making model.⁴³

8.2.2.1 No frustration, passivity, and competing bids

The 'no frustration' rule, even though it allocates the decision on the acceptance of the bid to the target shareholders, does not impose a 'passivity rule' on the incumbent management. There are a number of situations in which the target board, consistently with the 'no frustration' rule, may take action which may significantly influence the outcome of the offer. To this extent the board does not have to be neutral towards the offer. First, incumbent management remains free to persuade shareholders to exercise their right of choice in a particular way and, indeed, in most jurisdictions the target board is required to provide the shareholders with an opinion on the offer. This recognizes the role of the incumbent management in addressing the information asymmetry problems of the target shareholders. The question of whether the 'no frustration' rule should give way in a more fundamental sense to the need to address target shareholders' coordination problems is addressed below.⁴⁴

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

Third, the rule is usually understood as a negative one and not as requiring incumbent management to take steps to facilitate an offer to the shareholders

and so pre-bid approval by shareholders seems unimportant in practice. See K.J. Hopt, *Obstacles to corporate restructuring: Observations from a European and German perspective*, in M. Tison, H. De Wulf, C. Van der Elst and R. Steennot (eds.), *PERSPECTIVES IN COMPANY LAW AND FINANCIAL REGULATION: ESSAYS IN HONOUR OF EDDY WYMEERSCH*, pp. 373-95 (2009).

⁴¹ METI and Ministry of Justice, *Guidelines Regarding Takeover Defense*, 27 May 2005, p.2. These guidelines are not legally binding in themselves but seek to capture court decisions and best practice.

⁴² See the warrants issued as a defensive measure in the recent *Bulldog Sauce* case, which both the District and Supreme Courts upheld on the main ground that the action had been approved by the shareholders after the bid had been launched and acquirer was treated fairly in respect of its pre-bid holdings (if not in the same manner as the other shareholders of the target): S. Oaki, *The Bulldog Sauce Takeover Defense*, 10 NAMURA CAPITAL MARKETS REVIEW No. 3, 1 (2007).

⁴³ Guidelines, p.3, though even these should be removable at the will of the shareholders. For Germany see *supra* note 40.

⁴⁴ See *infra* 8.2.5.

(except in some cases where a facility has already been extended to a rival bidder). Thus, the no-frustration rule is not interpreted as requiring the target management to give a potential bidder access to the target's books in order to formulate its offer. In the case of private equity, and even some trade, bidders, this may give the management of the target something approaching a veto over the control transaction or, at least, give it significant negotiating power with the bidder as to the terms of the offer.⁴⁵

Moreover, developments elsewhere in company and securities law may enhance the possibilities noted in the previous paragraph. Recent developments in requirements for disclosure of the beneficial ownership of voting shares, although primarily aimed at the prevention of false markets, in fact help incumbent management by increasing the time available to them to prepare the defensive steps permitted to them. Most jurisdictions now have rules requiring the beneficial holders of shares in listed companies, whether acting alone or in concert, to disclose that fact to the company and the market when certain minimum levels are exceeded.⁴⁶ The beneficial owner may also be required to disclose, not just the fact of the ownership, but also its intentions in relation to control of the company.⁴⁷ Some jurisdictions employ a further technique and permit the company to trigger a disclosure obligation.⁴⁸

8.2.2 *White knights and competing bids*

Finally, the 'no frustration' rule does not normally prevent an incumbent management from seeking to enlarge the shareholders' choice, for example, by seeking a 'white knight'. Whether or not sought by the incumbent management, a competing bidder may emerge. This event may seem unproblematic because it

⁴⁵ Given the leveraged nature of the typical private equity offer, the acquirer needs to be very sure about the target's income-generating potential. Of course, the shareholders may pressurize the board to open the company's books to the potential bidder, even if the management are reluctant to do so, but the management do not require shareholder approval to stand pat.

⁴⁶ Most national laws require disclosure at the 5% mark. There is also the beginnings of a trend towards mandatory disclosure of economic interests in shares, whether or not accompanied by an ownership interest. See, for example, *CSX Corp v. The Children's Investment Fund (UK) LLP* 562 F. Supp 511 (2008) bringing equity swaps within § 13(d) of the Securities Exchange Act 1934; FINANCIAL SERVICES AUTHORITY (UK), *Disclosure of Contracts for Differences*, CP 08/17, October 2008, proposing extended disclosure rules from September 2009. Cf. the acquisition by Schaeffler of an undisclosed 28% stake in Continental via CDDs before announcing a takeover in May 2008; and the undisclosed increase in the same way of Porsche's stake in Volkswagen from 43% to 74% in October 2008, which led to a severe short squeeze in Volkswagen's shares, given that 20% of the shares were held by the State of Saxony and were not available for sale. See <http://www.thededge-fundjournal.com/research/sf-berwin/fm-alert-the-volkswagen-case.pdf>.

⁴⁷ § 13(d) Securities Exchange Act 1934 (US); Art. L. 233-7VII Code de commerce (France)—but this additional information is required only at the 10% and 20% levels; Risk Limitation Act 2008 (*Risikobegrænsningsloven*), again at the 10% level (Germany); Art. 27-23 et seq. of the Financial Instruments and Exchange Act 2006 (Japan).

⁴⁸ Companies Act 2006, Part 22 (UK)—this is not tied to any particular level of shareholding and involves an obligation to respond to the company's request, in default of which the company may seek an order from the court suspending the right to transfer or vote the share.

appears not to constrain the shareholders' choices but rather to enlarge them. The wealth-enhancing impact of competing bids as far as target shareholders are concerned is well established in the empirical literature. However, this may be true in relation to a particular offer, but not in relation to the universe of offers. The cost associated with rules which facilitate competing bids is that they reduce the incentives for first offers to be made. First bidders often lose out if a competitor emerges, and in that situation the search and other costs incurred by the first bidder will be thrown away. This will discourage first bidders generally and so reduce the number of offers.⁴⁹ It is thus significant whether the 'no frustration' rule permits the seeking of a 'white knight' and, more generally, whether other rules on the conduct of a bid in fact help or hinder competing bidders.

As Romano has remarked,⁵⁰ 'any regulation that delays the consummation of a hostile [or even a friendly] bid... increases the likelihood of an auction by providing time for another bidder to enter the fray, upon the target's solicitation or otherwise.' Thus, rules ostensibly aimed at other problems may have a significant impact on the chances that an alternative offer will be forthcoming. An example is rules which require the bid to remain open for a certain minimum period of time (in order that shareholders shall not be pressurized into accepting the offer before they have had a chance to evaluate it). Another is rules, just discussed, requiring disclosure to the market of the beneficial ownership of shareholdings above a certain size⁵¹ which may give a potential competitor advance warning that an offer for a particular target company is likely to be forthcoming.⁵² If a competitor does emerge, whether through the actions of the target management or not, its task is facilitated in those systems which permit acceptors to withdraw their acceptance of the first offer, unless it has been declared unconditional, either for any reason or if a competing offer emerges.⁵³ To the same effect are rules giving competing bidders equal treatment with the first bidder as far as information is concerned.⁵⁴

There are a number of techniques which can be used to mitigate the downside to the first bidder of rules which facilitate competing bids.⁵⁵ Where the directors of the potential target judge that it is in the shareholders' interests that a bid

⁴⁹ Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARVARD LAW REVIEW 1161 (1981). The debate is examined by Romano, Roberta Romano, *A Guide to Take-overs: Theory, Evidence and Regulation*, in Klaus J. Hopt and Eddy Wymeersch (eds.), EUROPEAN TAKEOVERS: LAW AND PRACTICE 3 (1992), 27-38, 50 *Ibid.* at 28.

⁵¹ See *supra* note 46.

⁵² Securities Exchange Act 1934, § 13(d)(1)(C) (US); Art. L. 233-7VII Commercial Code (France);

⁵³ This is the predominant rule in takeover regulations, even in the U.S. (see § 14(d)5 1934 Securities Exchange Act and Rule 14d-7)—though not in the UK (Code on Takeovers and Mergers, Rule 34, allowing withdrawals only more narrowly). The bidder may seek to avoid this rule by obtaining irrevocable acceptances outside the offer (and usually before it is made)—though the acceptor may choose to make the acceptance conditional upon no competing bidder emerging.

⁵⁴ *Ibid.* 8.2.5.1.

⁵⁵ For further analysis see Koutouridas, *supra* note 32, Chs. 6 and 7.

be made for their company and that an offer will not be forthcoming without some protection against the emergence of a competitor, the directors of the target could be permitted to contract not to seek a white knight.⁵⁶ More effective from the first offeror's point of view would be a financial commitment from the target company in the form of an 'inducement fee' or 'break fee', designed to compensate the first offeror for the costs incurred if it is defeated by a rival. Such fees are common in the U.S., but treated with reserve in the UK because of their potential impact upon the principle of shareholder decision-making.⁵⁷ They could be used to give a substantial advantage to the bidder preferred by the incumbent management. Finally, the first offeror could be left free to protect itself in the market by buying shares inexpensively in advance of the publication of the offer, which shares it can sell at a profit into the competitor's winning offer if its own offer is not accepted. Although pre-bid purchases of shares in the target (by the offeror) do not normally fall foul of insider dealing prohibitions,⁵⁸ rules requiring the public disclosure of share stakes limit the opportunity to make cheap pre-bid purchases of the target's shares.⁵⁹

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

8.2.3 Joint decision-making

Where management is permitted unilaterally to take effective defensive measures in relation to an offer, the process of decision-making becomes in effect a joint one involving both shareholders and management on the target company's side. Unless the target board decides not to take defensive measures or to remove those already implemented, the offer is in practice incapable of acceptance by the shareholders. Perhaps the best known of such measures is the 'poison pill' or shareholders' rights plan, as developed in the United States. Here, the crossing by an acquirer of a relatively low threshold of ownership triggers rights for target shareholders in relation to the shares of either the target or the acquirer, from

⁵⁶ This is the situation in the UK: see *Dawson International plc v. Coats Patons plc* [1990] BUTTERWORTHS COMPANY LAW CASES 560. Self-interested use of this power is then policed by subjecting its exercise to court review by reference to the board's fiduciary duties. Even so, if despite the contractual undertaking, a competing bidder does emerge, the target board may not contract out of its fiduciary duty to advise its shareholders about which bid is in their interests.

⁵⁷ They are usually in the 2–5% range in the U.S., whilst rule 21.2 of the City Code sets an upper limit on inducement fees of 1% of the offer value. It also requires the arrangement to be disclosed in the offer document and the offeree board and its financial adviser to confirm to the Panel that they believe the inducement fee is in the best interests of the target shareholders.

⁵⁸ See, e.g., Recital 29 to the Directive of the European Parliament and of the Council on insider dealing and market manipulation (2003/6/EC, [2003] OJ L 096/16). Details are controversial: cf. Klaus J. Hopp, *Takeovers, Secrecy and Conflicts of Interest*, in Jennifer Payne (ed.), TAKEOVERS IN ENGLISH AND GERMAN LAW 9 (2002) 33, 38–50.

⁵⁹ See *supra* note 46.

which the acquirer itself is excluded and which render the acquisition of further shares in the target fruitless or impossibly expensive.⁶⁰ Whilst the poison pill is not mandatory, the ease with which it can be adopted by management of potential target companies renders it widespread in practice in U.S. companies. It is also a powerful legal technique, apparently putting the incumbent management in a position where they can 'just say no' to a potential acquirer.⁶¹

The success of the poison pill defence depends, it should be noted, not simply upon its effect on the acquirer but also upon the target management having power under general company law and the company's constitution to adopt the plan containing these contingent rights without the approval of the shareholders and upon the courts' holding it not to be a breach of the directors' duties to adopt or to refuse to remove the plan in the face of a bid. In the absence of these features, a shareholders' rights plan will not necessarily produce joint decision-making by shareholders and target management. Thus, although allegedly modelled on the poison pill, the power given to target companies in the recent French reforms to issue share warrants does not have by any means the same potential for management entrenchment. Under the French rules, the decision must be taken by the shareholders, either themselves to issue the warrants or to authorize management to do so; and this decision must be taken during the bid period. Only if the acquirer's management would not be subject to a neutrality rule, were it a bid target (i.e., if there is no 'reciprocity'), may the shareholders authorize the management to issue warrants in advance of a bid.⁶² Thus, under the French rule, while the legal mechanism is similar to the U.S. one, it is firmly under the control of the shareholders, at least in cases of reciprocity.⁶³ Where there is no reciprocity, the rule constitutes the weak form of the 'no frustration' rule.⁶⁴

More generally, the possibilities for the incumbent board to insert itself into the decision-making process on the bid (whether through a shareholder rights

⁶⁰ This definition of a poison pill is taken from Lucian A. Bebchuk and Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUMBIA LAW REVIEW 1168 (1999) (citing, in their footnote 35, the chief economist for the Securities and Exchange Commission). See also, by the same authors, *On Takeover Law and Regulatory Competition*, 57 THE BUSINESS LAWYER 1047 (2002).

⁶¹ 'The passage of time has dulled many to the incredibly powerful and novel device that a so-called poison pill is. That device has no other purpose than to give the board issuing the rights the leverage to prevent transactions it does not favor by diluting the buying proponent's interests (even in its own corporation if the rights "flip-over").' Strine V-C in *Hillinger Inv't v. Black*, 844 A.2d 1022 (2004, Del. Ch.) at para. 111.

⁶² Art. L. 233–32 II and 33 of the Commercial Code, inserted by law no. 2006–387 of 31 March 2006 concerning public offers, Arts. 12 and 13. Also the warrants (*bons d'offre*) must be issued to all the shareholders, including the acquirer in respect of its pre-bid shareholding (though the shares which it has agreed to acquire through the bid do not count for entitlement to the warrants). Subject to this partial exception, the boards of French companies are now subject to an explicit neutrality rule (Art. L. 233–32 I), though the prior law, which was much less clear, was interpreted in this way as well.

⁶³ For further discussion of the reciprocity rule see *infra* 8.3.2.

⁶⁴ See *supra* 8.2.2.

plan or in some other way) will depend, in the absence of a 'no frustration' rule, upon the extent to which shareholder approval is required, whether by general corporate law or the company's articles, for particular decisions.⁶⁵ Normally, the powers of centralized management are extensive in the relation to the handling of the company's assets, but in many jurisdictions they are more constrained where issues of shares or securities convertible into shares are concerned, because of their dilution potential for the existing shareholders. Yet, in principle, defensive measures which focus on the company's capital rather than its business assets may be more attractive to incumbent management, because they are less disruptive of the underlying business or a more powerful deterrent of the acquirer. Thus, in the European Community general rules requiring shareholder approval for increases in capital inhibit, though do not completely rule out, shareholder rights plans adopted unilaterally by incumbent management.⁶⁶ Equally, the recent development of share warrants as a defensive measure in Japan was premised upon changes in general corporate law (not aimed specifically at the control shift situation but at implementing a more general deregulation programme) which expanded the board's share-issuing powers. In particular, the board was empowered to issue stock options without having to seek shareholder approval, though the court may prevent 'unfair issuance'.⁶⁷ Whether it is legitimate for the board to use its powers to defeat a takeover is, of course, a separate question, but without the power, the question does not even arise.

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

Although the 'no frustration' rule is not a fully-fledged passivity rule, it nevertheless operates so as to put the shareholders in the driving seat as far as decision-making on the offer is concerned. Putting the shareholders in a position where they can deal with their coordination problems as against the acquirer then becomes a significant concern of the rules applying to control shifts which are based on the 'no frustration' principle. By contrast, joint decision-making strategies permit the incumbent management to negotiate on behalf of the shareholders and to take other steps in their interests, such as rejecting bids which undervalue the company. If, within a joint decision-making system, it is possible to secure that the incumbent management's decision-making power is used in the shareholders' interests rather than to promote the self-interest of the management in retaining their positions, it can be argued that the outcome is superior to

that achieved by lodging the decision right wholly with the shareholders, because the shareholders' coordination problems are circumvented where incumbent management negotiates on their behalf.⁶⁸ However, to achieve this result, a joint decision-rights strategy needs to be accompanied by one or more other strategies, if the risk of self-serving use by the management of its veto power is to be avoided. There is a range of strategies which could be deployed to this end: standards, trusteeship, removal rights, and reward strategies.

8.2.3.2 Standards

Ex post scrutiny by a court of the exercise of the veto power by management is the most obvious additional legal strategy to apply, since the decisions of centralized management, whether in relation to control transactions or not, are routinely subject to such review in most jurisdictions. It has been argued⁶⁹ that in the 1980s the Delaware courts applied fiduciary duties to directors in such a way as indeed to sustain refusals to redeem poison pills only where the bid was formulated abusively as against the target shareholders. At this time, therefore, it could be argued that the poison pill was generating an efficient set of responses to the agency and coordination problems of the target shareholders: directors could exercise their discretion to block the opportunism of acquirers but not to further their own interests in the preservation of their jobs. However, with the development by the Delaware courts of the 'just say no' rule, the impact of the poison pill changed significantly. The starting point of this new approach was the adoption of the view that decisions on the fate of a bid are in principle as much a part of the management of the company, and thus within the province of the directors, as any other part of the board remit.⁷⁰ Sole decision-making had to be given to the shareholders (and indeed a policy of neutrality adopted among the competing bidders) only if the incumbent management, as part of its strategy, had reached a decision to sell control of the company or to dispose of its assets.⁷¹ But the decision to maintain the business as a going concern in the hands of the incumbent management was one that the board was in principle free to take, whether or not it thought the offer to be wealth maximizing from the shareholders' point of view. Thus, from a shareholders' perspective, joint decision-making over control shifts

⁶⁸ The attractiveness of this argument depends, of course, on (a) how easily the shareholders' coordination problems can be addressed if management is sidelined (*supra* 8.2.5) and (b) how much scope for negotiation is left to the incumbent board under the no-frustration rule (*supra* 8.2.1).

⁶⁹ Lucian Bebchuk, *The Case Against Board Veto in Corporate Takeovers* 69 UNIVERSITY OF CHICAGO LAW REVIEW 973 at 1184-8 (2002). See also R. Gilson, *UNOCAL Fifteen Years Later (and What We Can Do About It)*, 26 DELAWARE JOURNAL OF CORPORATE LAW 491 (2001).

⁷⁰ *Paramount Communications Inc. v. Time Inc.*, 571 ATLANTIC REPORTER SECOND SERIES (hereafter A.2d) 1140 (1989); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (1985); *Unitrin Inc. v. American General Corporation*, 651 A.2d 1361 (1995).

⁷¹ *Revlon Inc. v. MacAndrew & Forbes Holdings Inc.*, 506 A.2d 173 (1986); *Paramount Communications v. QVC Network*, 637 A.2d 34 (1994).

⁶⁵ See *supra* 3.4 and 7.

⁶⁶ The Second Company Law Directive [1977] O.J. L 26/1, requires shareholder approval for increases in capital (Art. 25). See in general Guido Ferrarini, *Share Ownership, Takeover Law and the Contestability of Corporate Control* (2002), available on <http://ssrn.com/abstract=265429>, and *supra* 7.2.

⁶⁷ Arts. 210 and 247 of the Companies Act.

will have a significant downside if the courts' approach to review of board decisions is essentially managerialist.⁷²

In Japan as well, in the absence of shareholder approval, the governmental guidelines and court decisions anticipate that defensive action by target management will be lawful only where it enhances 'corporate value' and promotes the shareholders' interests. Consequently, defensive measures not approved by the shareholders will stand a greater chance of meeting this standard if the bid is coercive, animated by greenmail or based on information asymmetry as between acquirer and target shareholders.⁷³ However, the flexibility, perhaps the unreliability, of this standard is demonstrated by the characterization by the Tokyo High Court of the bidder in the *Bulldog Sauce* case as 'abusive' simply because it was a shareholder with purely financial interests in the target.⁷⁴

In general, in all jurisdictions there will be overarching duties applying to decisions of the board—such as the duty to act in the best interests of the company or to exercise powers only for a proper purpose—from which even a specific legislative mandate to take defensive measures will not normally relieve the management. However, there is little evidence that the courts are willing to scrutinize rigorously over long periods of time the discretion vested in management under the dual decision-making model.⁷⁵

8.2.3.3 Trusteeship

An alternative to going outside the company for review of defensive measures proposed by management is to seek approval within the company from independent directors. Thus, in Germany the managing board has two possibilities for taking defensive action but both turn on the action being approved by the supervisory board.⁷⁶ This strategy depends for its effectiveness (from the shareholders' point

⁷² In many U.S. states the managerialist approach was adopted legislatively through 'constitutive' statutes which, whilst appearing to advance the interests of stakeholders, in particular labor and regional interests, in practice operated—and were probably intended to operate—to shield management from shareholder challenge. Romano, *supra* note 49, at p. 40 and 8.5 *infra*.
⁷³ METI and MoJ Guidelines, *supra* note 41, at pp. 1–2 and see the discussion of the *Lineador* and other cases by Kozuka, *infra* note 95, at pp. 12–16.

⁷⁴ Osaka, *supra* note 42 at pp. 7ff.

⁷⁵ Thus, in Germany the managing board's power to take defensive action with the consent of the shareholders and/or the supervisory board will not relieve it of its duty to act in the best interests of the company. There is much academic discussion of what this limitation means, but it is doubtful whether it prevents management entrenchment except in egregious cases. The same appears to be true of Italy which in 2008 repealed its 'no frustration' rule but left boards subject to the laws on directors' duties. However, there is some evidence that the Delaware courts have done a better job with the standards strategy when it has been deployed to control managerial promotion (rather than resistance to) control shifts. See Robert B. Thompson and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VANDERBILT LAW REVIEW 113 (2004).

⁷⁶ The managing board may seek the advance approval of the shareholders for defensive measures but then any exercise of the power must be approved by the supervisory board (§ 33(2) *Urbahnengesetz*) or it may take defensive measures simply with the approval of the supervisory board (§ 33(1) *Urbahnengesetz*, last sentence). Only the last-minute amendments to § 33 in the

of view) heavily on the ability of the supervisory board to play a genuinely independent role. This may be questionable in the case where the board is codetermined, since the employee representatives on the supervisory board will typically favor the management's rather than the shareholders' standpoint.⁷⁷ Equally, to the extent that board decisions in the U.S. to redeem or not a poison pill are taken by the independent members of the board, that jurisdiction makes use of a trustee strategy. Here there are no complications arising from codetermination but the independence of the non-executives is still an open issue.⁷⁸

8.2.3.4 Removal rights

As management's decisions to turn away potential offers were upheld in the U.S. courts, shareholders responded by seeking to replace the existing board with those who would look on the bid more favorably. The effect of this development was to channel takeover bids into battles at the general meeting to replace the incumbent board with nominees of the bidder, who would remove the pill. In effect, this strategy gives greater emphasis to the role of collective shareholder decision-making, which is also to be found when post-bid defensive measures are subject to shareholder approval under the no frustration rule. In the latter case, however, a collective decision of the shareholders is a pre-condition for defensive measures to be taken by incumbent management; in the former, it is a pre-condition for the offer to be put to the shareholders of the target where the board will not deal with the bidder. The burden of obtaining shareholder approval falls on the target board under the former set of rules and on the bidder in the latter. This makes a crucial difference. The requirement to obtain shareholder approval before the offer is put to the shareholders, is restrictive of the acquirer.⁷⁹ The momentum behind the offer may well have been dispersed before the conditions for launching it have been realized. This is especially so if the vote can be obtained only at the end of the director's term of office or if more than one vote is needed because the company has a staggered board.⁸⁰ It has been argued that it is the combination of the poison pill with the staggered board which puts the management of legislative process explain this oddity. In practice, there seems little value to the management in obtaining prior approval of the shareholders.

⁷⁷ Hopt, *supra* note 40 at III.A.b.

⁷⁸ For an assessment of supervisory boards in two-tier board structures, see *supra* 3.2.

⁷⁹ On the advantages of the bid over a proxy fight see Louis Loss and Joel Seligman, *FUNDAMENTALS OF SECURITIES REGULATION* 562 (4th ed., 2001). Lucian Bebchuk and Oliver Hart, *Takeover bids versus proxy fights in contests for corporate control* (Harvard Law and Economics Discussion Paper No. 336; and ECGI—Finance Working Paper No. 04/2002. Available at SSRN: <http://ssrn.com/abstract=290584>) argued that in principle a speedy shareholder vote binding on all the shareholders is preferable to individual acceptances of a general offer as a way of deciding upon a bid, though they recognized that the American rules fall short of this scheme. In effect, this is an argument in favor of using the statutory merger procedure to effect a control transaction. See *supra* 8.1.1.

⁸⁰ This is where a proportion only—normally one-third—of the board can be removed at each annual shareholders' meeting.

the target in a powerful defensive position in the U.S., rather than the poison pill on its own, i.e., that the removal strategy would effectively constrain the board's use of the poisoned pill, if it were available.⁸¹

8.2.3.5 Reward strategy

Under this strategy the self-interest of the incumbent management in retaining their jobs is replaced by self-interest in obtaining a financial reward which is dependent upon surrendering control of the company to the acquirer.⁸² This may arise because rewards under general incentive remuneration schemes for managers are triggered upon a transfer of control,⁸³ or because payments can be claimed under the management's contracts of service,⁸⁴ or because, less often, ad hoc payments are made to the incumbent management, either by the acquirer or the target company, in connection with a successful control shift. Such payments are widely available in the U.S.; and it has been argued that the reward strategy has succeeded in bringing about, in terms of incentives not to invoke the poison pill, what the removal strategy failed to achieve.⁸⁵ Outside the U.S., however, it is often unacceptable or unlawful to make payments of a sufficient size to amount to a significant counter-incentive for the managers, at least without the consent of the shareholders, which, in the context we are considering, undermines the reward strategy.

Thus, in the *Mannesmann* case, a payment to the CEO of a German target company, after the successful takeover of that company by a (foreign) acquirer, led to criminal charges against him for corporate waste. Although the case was ultimately settled without admission of liability, the test laid down by the top civil court for criminal liability for waste was a tough and objective one.⁸⁶ It is possible to avoid this criminal liability by contracting in advance for the payment of compensation for loss of office, but it is difficult to believe that this decision will not chill

⁸¹ Bebchuk, Coates, and Subramanian, *The Powerful Antitakeover Force of Staggered Boards*, 54 *STANFORD LAW REVIEW* 887 (2002). More recent evidence suggests incumbent management is subject to shareholder pressure and financial incentives to de-stagger the board: M. Ganoor, *Why do Managers Dismantle Staggered Boards?*, 33 *DELAWARE JOURNAL OF CORPORATE LAW* 149 (2008).

⁸² M. Kahan and E. B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law* 69 *UNIVERSITY OF CHICAGO LAW REVIEW* 871 (2002); J. Gordon, *American Experience and EU Perspectives* in G. Ferrarini et al. (eds), *REFORMING COMPANY AND TAKEOVER LAW IN EUROPE* (2004).

⁸³ For example, because of accelerated stock options.

⁸⁴ For example, contractual golden parachutes.

⁸⁵ L. Bebchuk and J. Fried, *PAY WITHOUT PERFORMANCE* (2004) 89–91; Alessio M. Paces, *FEATURING CONTROL POWER* (2007) Ch. 6.3 (welcoming such a result on theoretical grounds as enabling a manager/entrepreneur to be compensated for idiosyncratic private benefits of control on a control shift, at a lower level of ownership of the company than she would aim for if such side-payments were not available); B. Holmstrom and S. Kaplan, *Corporate Governance and Manager Activity in the US: Making Sense of the 1980s and 1990s*, MIT, Department of Economics, Working Paper No. 01–11 (available at <http://www.ssrn.com>).

⁸⁶ BGH 21 December 2005, NJW 2006, 522.

the levels of both contractual compensation thought to be appropriate for pre-bid agreement and gratuitous payments post-acquisition. Even in the UK gratuitous payments in connection with loss of office after a takeover require shareholder approval, in the absence of which the payments are regarded as held on trust for the shareholders who accepted the offer.⁸⁷ This remedy nicely underlines the fact that strengthening the role of incumbent management in control shifts is likely to lead to the diversion to them of part of the control premium.⁸⁸ More generally, the moves in the UK towards greater shareholder scrutiny of executive director remuneration have constrained even contractual rewards dependent upon a successful takeover.⁸⁹ Since the financial incentives needed to compensate management for the monetary, reputational and psychological losses arising out of their removal from office are likely to be substantial, jurisdictions which regard such payments with suspicion are not likely to achieve any re-balancing of the incentives arising out of the adoption of joint decision-making on control transactions.

Overall, one can say that the initial decision-rights choice is likely to be highly significant. Whilst in some jurisdictions, notably the U.S., the deployment of additional strategies, especially the reward strategy, may produce a result in which the outcomes of the joint decision-making process are not significantly different (in terms of deterring value-enhancing bids) from those arrived at under the 'no frustration' rule, this conclusion is highly dependent upon those additional strategies being available and effective. In the absence of pro-shareholder courts with effective review powers, easy removal of incumbent management or the ability to offer significant financial incentives to management to view the bid neutrally, rejection of the 'no frustration' rule is likely to reduce the number of control shifts.⁹⁰

8.2.4 Pre-bid defensive measures

It has often been pointed out that a major limitation of the 'no frustration' rule is that the requirement for shareholder approval of defensive tactics applies only once a bid is in contemplation,⁹¹ even though management may well be

⁸⁷ Companies Act 2006, §§ 219 and 222(3). Contractual payments are also caught by this rule (§ 220), if agreed in connection with the bid.

⁸⁸ Referring to golden parachutes and accelerated stock options Gordon says: 'One way to understand these devices is as a buyback by shareholders of the takeover-resistance endowment that managers were able to obtain from the legislatures and the courts during the 1980s'. Gordon, *supra* note 82 at 555.

⁸⁹ Thus, it has been reported that, after the introduction of the shareholders' advisory vote on directors' remuneration, clauses providing for automatic vesting of directors' stock options on a change of control virtually ceased to be part of directors' remuneration packages. Deloitte, *Report on the Impact of the Directors' Remuneration Report Regulations* (November 2004) p. 19.

⁹⁰ Gordon, *see supra* note 82 at 555, making these points in relation to Germany, where neither easy removal of the board nor high-powered incentives to accept offers is available.

⁹¹ See Paul Davies, *The Regulation of Defensive Tactics in the United Kingdom and the United States*, in Hopt and Wymeersch, *supra* note 49, 195. If a defence put in place pre-bid, requires

able to act effectively against potential offers in advance of any particular offer materializing. The European Commission's High Level Group identified five categories of pre-bid defensive measures,⁹² consisting of barriers to (a) the acquisition of shares in the company (for example, ownership caps or poison pills⁹³); (b) exercising control in the general meeting (voting caps; multiple voting shares); (c) exercising control of the board of directors (codetermination, staggered boards, special appointment rights for some shareholders); and (d) exercising control of the company's assets (lock-ups); and creating (e) financial problems for the acquirer as a result of the acquisition (poison debt); or (f) regulatory issues (defensive acquisitions creating anti-trust problems if further consolidation).

The availability of pre-bid defenses does not simply create a gap in the regulation of management opposition to value-enhancing control shifts; it promises to undermine the 'no frustration' rule entirely. The situation becomes one where the board has a strong incentive to simply shift its defensive actions to the pre-bid period. However, because the 'no frustration' rule seeks to alter the normal allocation of decision-making powers as between shareholders and the board once a bid is imminent, to apply the 'no frustration' rule at all times, at least on the basis of an 'effects' test, would be too great an interference with the operation of centralized management.⁹⁴ Any commercial decision which might have the effect of deterring a future bidder for the company would have to be put to the shareholders for their approval. This issue arises in relation to the joint decision-making model as well, but in a less strong form. Since the board has much more influence under that model over the success of the offer, once it is made, it has a lesser incentive to put defensive measures in place pre-bid. Further, if there is an effective rewards strategy in place to induce management to accept offers which are wealth-enhancing for the shareholders, then that incentive structure actually discourages management from putting non-removable barriers in place pre-bid. The question of how to regulate pre-bid defences thus arises most acutely in the context of the adoption of a 'no frustration' rule.

action on the part of the board post-bid to be effective, then it will be caught by the no-frustration rule, for example, the issuance of shares by the board which the board has previously been authorized to issue.

⁹² *Report of the High Level Group of Company Law Experts Issues Related to Takeover Bids*, Brussels, January 2002, Annex 4. Some of these defensive steps could be taken, of course, post-bid as well.

⁹³ A poison pill may be adopted pre- or post-bid, normally the former. However, there is still a post-bid issue, namely, whether the directors redeem the pill (i.e., remove the shareholder rights plan), their unilateral power to do this being a central part of the scheme.

⁹⁴ Of course, the precise point at which the line between pre- and post-periods is drawn can be the subject of some debate. The City Code draws it once the board has reason to believe that a bona fide offer might be imminent' (see *supra* 8.2.2), whilst the Takeover Directive's (default) no frustration rule applies only when the board is informed by the bidder of its decision to make an offer. (Arts. 9.2 and 6.1)

8.2.4.1 Strategies for controlling pre-bid defensive measures

However, as with post-bid defensive decisions by incumbent management under the joint decision-making model, pre-bid defensive tactics are subject to other legal strategies. The most general of these are the standards applied by company law to all board decision-making (duties of care and loyalty). These standards are necessarily less constraining than the 'no frustration' rule, for the reasons just given, i.e., in order to preserve the benefits of centralized management. Typically, some form of a 'primary purpose' rule is used to distinguish legitimate from illegitimate decisions taken pre-bid which have defensive qualities as well as commercial rationales. Such rules necessarily give management considerable freedom to take action for which there is a plausible commercial rationale, even if that action has defensive qualities of which the directors are aware and welcome, for example, an acquisition of assets which will create competition problems for a future bidder or which will put a block of shares into friendly hands.⁹⁵

Rules dealing with specific decisions may be more constraining, but are necessarily also of less general impact. Rules on significant transactions may require shareholder approval of certain types of pre-bid corporate action with defensive qualities.⁹⁶ Thus, we have also noted that the Community rules on shareholder consent to capital issues have placed obstacles in the way of the straightforward adoption of 'poison pills' in Europe.⁹⁷ Here, pre-bid, the joint decision-making process is the more pro-shareholder choice, since the available alternative is not unilateral decision-making by shareholders but unilateral decision-making by the board. However, these veto rights for shareholders are generally driven by more general corporate law concerns than the control of pre-bid defensive measures and, hence, have a somewhat adventitious impact on control shifts.

Overall, management is necessarily given greater freedom to entrench itself pre-bid than post, and the legal strategies used to control managerial opportunism pre-bid are simply the general strategies used to protect the shareholders as principals and against the management as agents which are discussed elsewhere in this book.⁹⁸

⁹⁵ Even post-bid the courts may have difficulty applying the proper purpose rule so as to restrain effectively self-interested defensive action. See the discussion of the *Miyagi Vabe* litigation by S. Korunka in ZITTSCHLITZ FÜR JAPANISCHES RECHT No. 21, 10–11 (2006) and *Hawlowe's Nominees Pty Ltd v Woodside (Lake Entrance) Oil Co.* 42 AUSTRALIAN LAW JOURNAL REPORTS 123 (High Court of Australia) (1968).

⁹⁶ See *supra* Chapter 7 for a discussion of the extent to which significant decisions require shareholder approval.

⁹⁷ See *supra* 8.2.3.

⁹⁸ The 'break-through rule' is an exception to this statement, since it is a rule fashioned specifically to deal with the impact of a certain class of pre-bid defenses (mainly from category (b) on the High Level Group's list). However, we discuss this rule *infra* 8.3.2, since it addresses principally situations where there is a controlling shareholder.

8.2.5 Agency and coordination problems of target shareholders when there is no controlling shareholder

When an offer is put to the shareholders of the target company, they face, potentially, two sets of problems. As against the acquirer, they face significant coordination problems. This is because the decision to accept or reject the bid is normally made by the shareholders individually, rather than by way of a collective decision which binds everyone, and so there is considerable scope for a bidder to seek to divide the shareholder body. As against the target management, the shareholders still face agency issues, since the board's recommendation to them (for or against the offer) may not be disinterested. This issue can arise even under the joint decision-making model, where the board recommends the offer to the shareholders. Indeed, that endorsement (under either model) may constitute the manifestation of the agency problem: the offer may not be the best available or may not be wealth-enhancing for the shareholders, but the management may recommend it because it is the best offer from their point of view. This is particularly likely to be the case where the incumbent management are part of the bidding team, as in an MBO supported by a private equity fund. Laws specific to control transactions tend to concentrate on the target shareholders' coordination problems as against the acquirer, with the solution of their agency problems as against the target management as a subsidiary theme.

The coordination problems of shareholders may be mitigated to some degree through the board's negotiations with the potential acquirer. Under the joint decision-making model, the board is in a strong position to negotiate in this way (though it may prefer to negotiate in its own interests),⁹⁹ whilst even under the no frustration rule, the board retains a not-insignificant negotiating potential, as we have seen.¹⁰⁰ However, if there is effective specific regulation of the shareholders' coordination problems, the benefits from entrusting the target board with the task of protecting the shareholders against coercive offers are reduced, perhaps eliminated, whilst it becomes less necessary to incur the costs arising from the risk of board entrenchment.

We now turn to examine the legal techniques which can be deployed to reduce target shareholders' coordination and agency costs. We need to note that all these techniques have costs, in particular by reducing incentives to potential bidders to make offers. The strategies are: mandatory disclosure of information; the trustee strategy; and, above all, requiring shareholders to be treated equally, both substantively and in terms of being afforded an exit right.

8.2.5.1 Information asymmetry

Provision of up-to-date, accurate, and relevant information can help target shareholders with both their coordination and agency problems. In particular,

disclosure of information by target management reduces the force of one of the arguments in favor of the joint decision-making model, i.e., that manager's have information about the target's value which the market lacks.¹⁰¹ However, does the law need to stipulate what information shall be made available? Even without regulation, the target management and the acquirer are likely to generate a lot of information about both companies—and, in a hostile bid, to point out the weaknesses in each other's presentations. However, both sides are under strong incentives to hide unfavorable, and to exaggerate favorable, information. By controlling the types of information which can be distributed and the channels by which it is disseminated, such regulation may discourage unsubstantiated and unverifiable claims.

Company law, of course, contains information disclosure provisions which operate independently of control transactions. However, annual financial statements are often out of date and, despite the continuing reporting obligations applied to listed companies in most jurisdictions,¹⁰² it is likely that both the target board and the acquirer will be better informed about their respective companies than the target shareholders. Thus, it is not surprising to discover that a centrepiece of all specific control shift regulation, whether it is aimed that the target shareholders' coordination or agency problems, is an elaborate set of provisions mandating disclosure by both the target board and the acquirer for the benefit of the target shareholders. It is routine to find rules requiring the disclosure of information on the nature of the offer, the financial position of the offeror and target companies, and the impact of a successful offer on the wealth of the senior management of both bidder and target. Even if the regulation does little else, it will tackle the issue of information disclosure.

In an agreed bid, incentives for reciprocal criticism will be lacking, especially for MBOs, where the management of bidder and target is common—or, at least, significantly overlapping. Here incumbent management appears in a dual role: as fiduciaries for the shareholders and as buyers of their shares. In this context, rules requiring the board of the target to take independent advice on the merits of the bid and to disclose it to target shareholders acquire a particular importance.¹⁰³ Equally, where an MBO is on the table, but a competing bid emerges, a requirement that all the information given to (potential) external providers of finance to the MBO team must also be given to a competing bidder reduces the scope for target management to favor their own bid.¹⁰⁴ In jurisdictions without takeover-specific regulation on the matter, it may be possible to leave the issue to general

¹⁰¹ Ronald J. Gilson and Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: the Hindright Bias* in John Armour and Joseph A. McCahery (eds.), *AFTER ENRON* (2006) 57, noting, however, that target management may have a difficulty making the disclosed information credible.

¹⁰² This matter is discussed more fully in Chapter 9.

¹⁰³ City Code Rule 20.2 (Note 3).

¹⁰⁴ City Code Rule 3.1 (Note 1).

⁹⁹ *Supra* 8.2.3.1.

¹⁰⁰ *Supra* 8.2.2.1.

corporate law, notably the rules on self-dealing transactions.¹⁰⁵ Even where there is no MBO, the target directors may prefer one offer over the other and thus soft-pedal their comments on the preferred offer. Further, mandatory disclosure requirements can help the process by providing the materials on the basis of which gatekeepers such as investment bankers can evaluate the bid.

In addition, information rules in control transactions are usually premised on the view that information disclosure is ineffective unless shareholders are given enough time to absorb the information (or other people's analyses of the information) before they have to act on it. All takeover regulation requires offers to be open for a certain minimum time (practice seems to coalesce around the 20-day mark) and revised offers to be kept open for somewhat shorter periods.¹⁰⁶ The main counter argument against very generous absorption periods is the need to minimize the period during which the target's future is uncertain and, in particular, during which the normal functioning of the centralized management of the target is disrupted. In addition, mandatory minimum offer periods increase the chances of the emergence of a white knight, imposing a cost on acquirers and, possibly, upon shareholders of potential targets through the chilling effect upon potential bidders.¹⁰⁷ Given the role played by arbitrageurs in takeover bids and their ability to absorb information quickly, it is likely that the main practical effect of the minimum periods is to facilitate competing bids rather than under-standing of the information disclosed.

8.2.5.2 *Trusteeship strategy*

Target shareholders face the risk that the incumbent management will exaggerate the unattractive features of an offer they oppose and vice versa with one they support. As we have seen immediately above, a common response is to require the incumbent management to obtain 'competent independent advice' on the merits of the offer (usually from an investment bank) and to make it known to the shareholders. This is partly a disclosure of information strategy and partly a trusteeship strategy: the investment bank does not take the decision but it provides an assessment of the offer to which the shareholders must receive, the accuracy of which has reputational consequences for the bank. Where there is an MBO, the

¹⁰⁵ See Werner F. Ebke, *The Regulation of Management Buyouts in American Law: A European Perspective* in Hopf and Wymerssch, *supra* note 49, 304-6—though it should be noted that the transaction here is technically one between the director (or associated person) and the shareholders, not the company. In the case of MBOs of close companies common law jurisdictions may deal with the grosser information disparities by imposing a duty on the directors to disclose information to the shareholders as an element of their fiduciary duties (see, for example, *Coleman v. Myers* [1977] 2 New Zealand Law Reports 225, NZCA).

¹⁰⁶ The Williams Act (*supra* note 22) in the U.S. was motivated in particular by the desire to control 'Saturday night specials' i.e., offers to which the shareholders had an unreasonably short time to respond, the term being apparently used originally to refer to inexpensive hand-guns popular for use on Saturday nights.

¹⁰⁷ See a discussion of competing bids and the passivity rule, *supra* 8.2.2.2.

directors involved in the bidding team may be excluded from those responsible for giving the target's view of the offer, thus allocating that responsibility to the non-conflicted directors of the target.¹⁰⁸

8.2.5.3 *Reward (sharing) strategy*

A notable feature of laws aimed at the solving target shareholders' coordination problems is their adoption of the rule of equality of treatment of the shareholders of the target company—though this principle can be implemented with various degrees of rigour. The principle is aimed mainly at controlling acquirer opportunism: it strands in the way of acquirers which wish to put pressure on target shareholders to accept the offer, by promising some (normally those who accept early) better terms than others.¹⁰⁹ In general, systems which place decision-making on the bid in the hands of the shareholders alone have developed the equality principle more fully than those which have adopted the model of joint decision-making.

All systems recognize the equal treatment principle to some degree. It can be applied, first, within the offer (i.e., to require those to whom the offer is addressed to receive the same¹¹⁰ terms); second, as between those who accept the offer and those who sell their shares to the offeror outside the offer, whether before or after a formal offer is launched; and, third, as between those who sell their shares to an acquirer as part of a control-building acquisition and those who are left as shareholders in the company. In this third case, implementation of the equality principle goes beyond a sharing strategy and involves providing an exit right for the target shareholders.

The first level of equality is recognized in all our jurisdictions. Thus, 'front-end loaded' offers are ruled out; and prior acceptors receive the higher price if the offer is later increased. However, instead of formulating differential offers, the acquirer may seek to offer some target shareholders preferential terms by obtaining their shares outside the offer. One solution is to prohibit purchases outside the offer, though this rule can be sensibly applied only to purchases during the offer period.¹¹¹ An alternative strategy is to require the offer consideration to be raised to the level of the out-of-bid purchases. Where such purchases are permitted during the offer period, the imposition of a sharing rule seems universal. More difficult is the issue of whether pre-bid purchases should be subject to a sharing rule. The Takeovers Directive does not explicitly deal with this point,

¹⁰⁸ City Code, Rule 25.1 (Notes 3 and 4).

¹⁰⁹ Paul Davies, *The Notion of Equality in European Takeover Regulation*, in Jennifer Payne (ed.), *TAKEOVERS IN ENGLISH AND GERMAN LAW* 9 (2002).

¹¹⁰ Or equivalent terms, where the offer covers more than one class of share.

¹¹¹ See, for example, the French rule in Art. 232-14 of the General Regulation of the Autorité des Marchés Financiers (AMF). However, the latter prohibits market purchases of the target shares during the offer period only in share exchange offers, presumably on the grounds that the offer is not for cash.

but some jurisdictions impose a strict sharing rule triggered by recent pre-bid purchases.¹¹²

8.2.5.4 Exit rights: mandatory bid rule and keeping the offer open

The strongest, and most controversial, expression of the sharing principle is the requirement that the acquirer of shares make a general offer to the other shareholders once it has acquired sufficient shares by private contract (whether on or off market) to obtain control of the target. Control is usually defined as holding around one third of the voting shares in the company.¹¹³ This is the mandatory bid rule.¹¹⁴ It is a particularly demanding rule if, as is common, it requires that the offer be at the highest price paid for the controlling shares,¹¹⁵ and to give the shareholders the option of taking cash.¹¹⁶ Here the law, in imposing a duty on the acquirer to make a general offer, provides the shareholders with something they rarely have, namely, a right to exit the company and at an attractive price. The mandatory bid rule does not simply structure an offer the acquirer wishes in principle to make, but requires a bid in a situation where the acquirer might prefer not to make one at all.

Such a requirement might be defended on two grounds. First, although the rule cannot be explained on the basis of pressure to accept a general offer (the assumption is that there would not be one in the absence of the rule), the absence of a mandatory bid rule would permit the acquirer to put pressure on those to whom offers are made during the control acquisition process to accept those offers. Absent a mandatory bid rule, the acquirer is free to make the following statement, explicitly or implicitly: 'I offer you an attractive price for your shares. If you do not accept it now, you may lose the benefit of the offer and, in addition, find that your shares have declined in value because I will be prepared to make only a lower offer (or none at all) once I have obtained control of the company.' Where the offer is value-decreasing or its impact on the target is just unclear, use of the mandatory

¹¹² Rules 6 and 11 City Code (but requiring cash only where the pre-bid purchases for cash reach 10% of the class in question over the previous 12 months); § 31 *Übernahmengesetz* and § 4 *Übernahmengesetz-Angebotverordnung* (Germany) (requiring cash at the 5% level but only where that percentage was acquired for cash in the 3 months prior to the bid).

¹¹³ The Takeovers Directive leaves the triggering threshold to be decided by the member states. The Commission's Report on implementation (*supra* note 37), Annex 2, confirms the 'one third' choice by most member states but also shows that Latvia, Malta, and Poland have set it at 50% or higher.

¹¹⁴ The additional issues arising when a mandatory bid rule is imposed upon an acquirer who obtains the control block from an existing controlling shareholder controlling shareholder are discussed *infra* 8.3.1.

¹¹⁵ The Takeover Directive, Art. 5(4), imposes a highest price rule, subject to the power of the supervisory body to allow dispensations from this requirement in defined cases.

¹¹⁶ The Takeover Directive permits the mandatory offer to consist of 'liquid securities' but some members states (e.g., City Code rule 9) require the offer to be in cash or accompanied by a cash alternative.

bid rule to remove pressure to tender addresses a significant coordination issue of the shareholders as against the acquirer.¹¹⁷ However, where the bid is value-increasing, as far as the target company is concerned, it can be argued that the value of shares held by the non-accepting shareholders will be higher after the control shift than before, even if they remain in the company, so that providing the non-accepting shareholders with an exit right is not necessary, given the costs of the mandatory bid rule in reducing the number of control shifts (below). However, it may be difficult to identify *ex ante* which category of offer is in question, so that the choice in practice is between applying or not applying the mandatory bid rule across the board.

Moreover, though the offer may be value-increasing for the target company's shareholders as a whole, the non-controlling shareholders may not obtain in the future their pro-rata share of that value. The leads to the second rationale for the mandatory bid rule. It could be said that permitting the acquisition of control over the whole of the company's assets by purchasing only a proportion of the company's shares would encourage transfers of control to those likely to exploit the private benefits of corporate control. On this view, the mandatory bid rule constitutes a preemptive strike at majority oppression of minority shareholders and proceeds on the basis that general corporate law is not adequate to police the behavior of controllers. The mandatory bid rule thus anticipates that there is a strong likelihood of majority/minority conflicts after the acquisition of control, and gives the minority the option to exit the company before such problems manifest themselves.¹¹⁸ On this rationale, the mandatory bid rule should be accompanied by a prohibition on partial offers, even where, assuming a pro-rata acceptance rule, all target shareholders are treated equally. By extension, one would expect to find a rule requiring comparable offers to be made for all classes of equity share in the target, whether those classes carry voting rights or not.¹¹⁹

Mandatory bid rules are now quite widespread. The Takeovers Directive requires member states to impose a mandatory bid rule (whilst leaving a number of crucial features of the rule, including the triggering percentage, to be determined at national level).¹²⁰ However, the mandatory bid rule is not part of U.S.

¹¹⁷ Burkhardt and Pannuzi, *Mandatory Bids, Squeeze-Outs and Similar Transactions* in Ferrarini et al. (eds.) (*supra* note 82) at 748–53 prefer a mechanism based on a shareholder vote where a bidder is seeking to buy a controlling stake. It is not clear how this would operate where the bidder is assembling a controlling holding but no acquisition of controlling stake is involved.

¹¹⁸ It constitutes, in the concept developed by German law, an example of *Konzernregelung* (regulation of group entry). See A. Paeces, above note 85, at ch. 10.4.5, arguing for reliance on fiduciary duties to control future divisionary private benefits of control rather than a mandatory bid rule, but cf. Caroline Belle, A COMPARATIVE OVERVIEW OF THE MANDATORY BID RULE IN BELGIUM, FRANCE, GERMANY AND THE UNITED KINGDOM (2008), at 279–80, suggesting that the mandatory bid is the more effective European rule.

¹¹⁹ The City Code contains both such rules: see Rules 14 (offers where more than one class of equity share) and 36 (partial offers).

¹²⁰ Takeover Directive, Art. 5. The Commission's implementing report (Annexes 2 and 3) shows: that, whilst most states have put the triggering percentage near 30%, there are a number of

federal law nor the law of Delaware, perhaps because the shareholders' coordination problems are intended to be dealt with by target management.¹²¹

Whilst the mandatory bid rule effectively addresses the coordination problems of target shareholders as against acquirers in the context of particular transactions, it runs the risk of reducing the number of control transactions which occur. This is so for a number of reasons. First, the implicit prohibition on partial bids makes control transactions more expensive for potential bidders: either the bidder offers for the whole of the voting share capital and at a high price or it does not offer for control at all.¹²² Second, the mandatory bid rule may also require the bidder to offer a cash alternative when otherwise it would have been free to make a wholly paper offer. Third, the rules fixing the price at which the acquirer must offer for the outstanding shares may expose the acquirer to adverse movements in the market between the acquisition of de facto control and the making of a full offer. As we see below,¹²³ these costs of the mandatory bid rule to minority shareholders are particularly high where there is a controlling shareholder, but they exist also where the acquirer builds up a controlling stake by acquisitions from non-controlling shareholders. On the other hand, the mandatory bid rule discourages acquisitions driven by the prospect of private benefits of control, in the form of diversion of corporate assets and opportunities to the controller, through the risk to the acquirer that it will end up with all or nearly all of the shares.¹²⁴

Some, but by no means all, takeover regimes have responded to these concerns, either in the formulation of the rules relating to the fixing of the price for the general offer or by extending the list of exceptions to the rule. Thus, Swiss law requires only that the offer be at not less than the higher of the market price when the mandatory offer is launched and 75% of the highest price paid for the shares over the previous 12 months.¹²⁵ The Takeovers Directive¹²⁶ permits the supervisory authorities to identify specific situations in which the mandatory bid

states with much higher triggers: that, apparently, there are variations over the meaning of 'holding securities', notably how far having an interest in securities is equated with holding securities; that derogation provisions vary considerably from state to state; and that most states do not deal with consolidation of control.

¹²¹ In any event partial bids are in fact rare in the U.S.

¹²² See e.g., Clas Bergström, Peter Höglfeldt, and Johan Molin, *The Optimality of the Mandatory Bid*, 13 JOURNAL OF LAW, ECONOMICS AND ORGANIZATION 433 (1997); S. Rossi and P. Volpin, *Cross-Country Determinants of Mergers and Acquisitions* 74 JOURNAL OF FINANCIAL ECONOMICS 277 (2004), showing that takeover premia are higher in countries with strong shareholder protection, especially those with mandatory bid rules.

¹²³ *Idem* 8-3.1.

¹²⁴ Thus, the mandatory bid rule discourages inefficient transfers of control. The balance between that effect and its discouragement of efficient transfers of control is disputed. See L. Bebochuk, *Efficient and Inefficient Sales of Corporate Control* 109 QUARTERLY JOURNAL OF ECONOMICS 854 (1994); M. Kahan, *Sales of Corporate Control* 9 JOURNAL OF LAW ECONOMICS AND ORGANIZATION 368 (1993).

¹²⁵ Art. 32(4) Loi sur les bourses (Switzerland).

¹²⁶ Art. 5.4. Italian law previously had provided for a discount from the highest price rule, but the directive caused this provision to be dropped.

rule many be set aside.¹²⁷ Italy permits partial bids for at least 60% of the shares, provided the shareholders other than the offeror and connected persons approve the offer by majority vote and the offeror has not acquired more than 1% of the shares over the preceding 12 months.¹²⁸

Japan addresses some of the above problems through a mandatory bid rule which also permits partial offers. Someone seeking to obtain more than one third of the shares of a listed company may not do so by private purchase but only via purchase over the exchange or by means of a regulated pro-rata offer (called a tender offer) to all the shareholders. Only if the aim is to acquire two thirds or more of the shares must the offer be to purchase all the outstanding shares.¹²⁹ In effect, the mandatory bid rule is triggered only at the two-thirds threshold. This rule facilitates control shifts and equal treatment of shareholders but without fully providing protection for minority shareholders.¹³⁰

Switzerland permits shareholders of potential target companies to choose between the protection of the mandatory bid rule in its full form or modifying it to encourage changes of control. The Swiss regulation permits the shareholders to raise the triggering percentage from one-third (the default setting) to up to 49% or to disapply the obligation entirely.¹³¹ Of course, such provisions still leave the burden of proof on those arguing against the mandatory bid rule.

The need to tailor the initial rigour of the mandatory bid rule, as described above, adds considerably to its complexity. So also does the need to close obvious avoidance loopholes. Thus, the rule will usually apply to those 'acting in concert' to acquire shares,¹³² not just to single shareholders. This idea has been implemented in a variety of ways in jurisdictions.¹³³ The rule can also be avoided if it does not include both the acquisition of economic as well as legal interests in shares.¹³⁴

¹²⁷ Member states have made use of this flexibility to grant exemptions where other policy objectives override that of minority shareholder protection, for example, where dispensation from the mandatory bid rule is required to facilitate the rescue of a distressed corporation.

¹²⁸ Legislative Decree No. 58 of 24 February 1998 (as amended) Art. 107.

¹²⁹ Arts. 27-2(1) and 27-2(5) of the Financial Instruments and Exchange Act; Art. 8(5)(iii) of the Ordinance for Implementing the Act.

¹³⁰ And it must chill sales of controlling blocks, because the existing controller will not be sure to dispose of the whole of the shareholding.

¹³¹ Arts. 22(2) and 32(1) Loi sur les bourses. These provisions must be contained in the company's constitution. In the case of total displacement this rule cannot be introduced after the company has become listed.

¹³² Takeovers Directive, Art. 5. There is a considerable danger that the acting in concert extension will chill shareholder activism, a development which policy-makers may or may not welcome. Contrast the Risk Limitation Act 2008 in Germany (discussed by Höpfi, *supra* note 40 at III B) with the City Code, Note 2 to Rule 9.1.

¹³³ Leading to proposals for greater harmonisation with the EU: see European Securities Markets Expert Group, *Preliminary Views on the Definition of Acting in Concert between the Transparency Directive and the Takeover Bids Directive*, November 2008.

¹³⁴ The City Code includes both securities' and the notion of acquisition of shares. See Rule 9.1 and the definition of 'interests in securities'. The extension to long economic exposures is recent and results from recognition that a person in this position can normally control the voting rights

The exit right in control transactions is associated above all with the mandatory bid rule, just discussed. However, a minor form of the exit right can be found in the obligation, imposed in some jurisdictions, upon an offeror to keep the offer open for acceptance, even after it had closed under the terms attached to the offer by the bidder. As Bebnuk has demonstrated, pressure to tender can be generated without breaching the equality principle in the formulation of the offer or by making purchases at a higher price outside the offer. Shareholders may still come under pressure to accept a uniform offer, which they regard as less than optimal and therefore wish to reject, for fear of being locked into the target as minority shareholders if the majority of the shareholders take a different view.¹³⁵ However, the solution to this problem is relatively simple, namely, the extension of the limit for acceptance of the offer to embrace a short period after it has become clear that a majority of the shareholders have accepted the offer.¹³⁶ In other words, a dissenting shareholder is given the opportunity to change his or her mind in favor of the offer once the crucial piece of information previously lacking—the decision of the majority of the other shareholders—has been provided.¹³⁷

8.3 Agency Issues upon Acquisition from an Existing Controlling Shareholder

Where there is a controlling shareholder or shareholding group the allocation of the decision on the offer as between the shareholders alone and shareholders and target board jointly loses much of its significance, for, on either basis, the controlling shareholder is likely to determine whether the control shift occurs.¹³⁸

attached to or acquire on settlement the shares bought by the counterparty as a hedge. See also *supra* note 46. The City Code is also unusual in applying the mandatory bid rule to any acquisition of voting shares by a shareholder holding between 30 and 50% of the voting shares. Many jurisdictions either have no 'creeping control' provisions or grant exemptions for acquisitions of up to 2% in any one year. See Commission Report, *supra* note 37.

¹³⁵ Lucian A. Bebchuk, *Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DELAWARE JOURNAL OF CORPORATE LAW 911 (1987). See however Subramanian, *A New Takeover Defense Mechanism: Using an Equal Treatment Agreement As an Alternative to the Poison Pill*, in 23 DELAWARE JOURNAL OF CORPORATE LAW 375, 387 (1998).

¹³⁶ See, e.g., Rule 31.4 City Code (UK) (but qualified by Rule 33.2); § 16(2) *Übernahmegesetz* (Germany), both adopting a two-week period.

¹³⁷ For a less effective alternative, because pitched at a higher level of shareholding, see the 'sell-out right' *infra* 8.4.

¹³⁸ This depends, of course, on the board being immediately responsive to the wishes of the majority (see 3.1.1). If it is not, even a majority holder may not be able to assert its will. For a striking example see *Hollinger Int'l v. Black*, 844 A.2d 1022 (2004), Del. Ch.), where the Delaware Court of Chancery upheld the power of the board of a subsidiary to adopt a shareholders' rights plan in order to block a transfer by the controller of the parent of his shareholding in the parent to a third party. This case involved egregious facts. In particular, the controller of the parent was in breach of contractual and fiduciary duties (as a director of the subsidiary) in engaging in the transfer, and the transferee was aware of the facts giving rise to the breaches of duty.

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

8.3.1 Exit rights and premium-sharing

In relation to the first issue, the central question is, again, whether the law imposes a sharing rule when there is a sale of control.¹³⁹ This question may be approached either from the side of the selling controlling shareholder (i.e., by imposing a duty on the seller to share the control premium with the non-selling minority (sharing of the consideration), or, from the side of the acquirer (i.e., by imposing a duty upon the purchaser of the controlling block to offer to buy the non-controlling shares at the same price as that obtained by the controlling shareholder (sharing of both the consideration and the exit opportunity).

Looking first at obligations attached to the selling controlling shareholder, some jurisdictions in the U.S. have used fiduciary standards to impose a sharing rule.¹⁴⁰ These duties may impose an obligation upon the controlling seller either to compensate the remaining shareholders for foreseeable harm caused by the sale¹⁴¹ or to share the premium with the non-controlling shareholders when the sale can be identified as involving the alienation of something belonging to all shareholders.¹⁴² However, these cases do not state the general rule. Despite some academic argument to the contrary,¹⁴³ U.S. courts have not adopted a general equality principle which might have led them to generate an unqualified right for non-controlling shareholders to share in the control premium. The law is probably best stated from the opposite starting point: a controlling shareholder has the same right to dispose of voting equity securities as any other shareholder,

¹³⁹ See *supra* 8.2.5.3–4.

¹⁴⁰ See also *supra* Chapter 6 (discussing controlling shareholders' fiduciary duties in the context of related party transactions).

¹⁴¹ As in the looting cases: see *Gerdes v. Reynolds*, 28 New York Supplement Reporter 2nd Series 622 (1941).

¹⁴² *Perman v. Felhman*, 219 FEDERAL REPORTER 2d Series 173 (1955); *Brown v. Halbert*, 76 CALIFORNIA REPORTER 781 (1969).

¹⁴³ William Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARVARD LAW REVIEW 505 (1965). For an incisive general discussion of this area see Robert Clark, CORPORATE LAW 478–98 (1986).

including... for a price that is not made proportionally available to other shareholders' but subject to a requirement for fair dealing.¹⁴⁴ Provided self-dealing is effectively controlled, permitting sales at a premium price gives both seller and acquirer an appropriate reward for their extra monitoring costs.¹⁴⁵ It is worth noting that, since the U.S. rules are a development of general fiduciary duties, they are apt to catch sales of control in closely held companies as well as in publicly traded ones.

As far as duties on the acquirer are concerned, many of the sharing rules discussed above will operate in favour of minority shareholders against a shareholder purchasing a controlling block, for example, the rules determining the level of the consideration.¹⁴⁶ Consequently, an acquirer that wishes to obtain an equity stake in the target beyond that which the purchase of the controlling block will provide may find it difficult to offer a sufficiently high price to the controlling shareholder to secure those shares if the rules require the subsequent public offer to reflect the price paid outside or prior to the bid. The greatest controversy, however, revolves around the question of whether the mandatory bid rule¹⁴⁷ should be applied to a transfer of a controlling position, so as to require the acquirer to make a public offer, where it would otherwise not wish to do so, and on the same terms as those accepted by the controlling seller.

It can be argued that there is a vital difference between sales of control and acquisitions of control, because, where the sale is by an existing controlling shareholder, the minority is no worse off after the control shift than they were previously. However, such a view ignores the risks which the control shift generates for the minority. The acquirer, even if it does not intend to loot the company, may embark upon a different and less successful strategy; may be less respectful of the minority's interests and rights; or may just simply use the acquired control systematically for implementing a group strategy at the expense of the new group member company and its minority shareholders.¹⁴⁸ It is very difficult to establish *ex ante* whether the minority shareholders will be disadvantaged by the sale of the controlling block, so that the regulatory choice is between reliance on general corporate law to protect the minority against unfairness in the future and giving the minority an exit right at the time of the control shift.¹⁴⁹

¹⁴⁴ American Law Institute, *PRINCIPLES OF CORPORATE GOVERNANCE*, 5.16.

¹⁴⁵ For the argument that in general the controlling shareholder should be free to transfer control, whether directly or indirectly, for the reason given in the text, see R. Gilson and J. Gordon, *Controlling Controlling Shareholders* 152 UNIVERSITY OF PENNSYLVANIA LAW REVIEW (2003-4) at 811-16.

¹⁴⁶ *Supra* 8.2.5.3. In most cases these rules can be avoided if the acquirer is prepared to wait long enough before launching an offer for full control.

¹⁴⁷ See *supra* 8.2.5.4.

¹⁴⁸ These are, of course, the arguments in favor of the mandatory bid rule, even where the seller is not a controlling shareholder. See *supra* 8.2.5.4. In the last case mentioned, it may be beneficial for the shareholders of the holding company to allocate business opportunities to another group member, but in that situation the minority shareholders in the new subsidiary will lose out.

¹⁴⁹ For a general discussion of this issue, see Jürgen Reul, *DIE PELICHT ZUR GEWICHTBEHANDLUNG DER AKTIONÄRE BEI PRIVATEN KONTROLLTRANSAKTIONEN* 277 et seq. (1991).

Nevertheless, the costs of the mandatory exit right are potentially much greater in a situation of transfer of control from a controlling shareholder than where control is transferred from the management of the target through acquisitions of non-controlling shares. In the latter case, transferors of the shares which become the controlling block have nothing more to sell the acquirer than any other shareholder (but for being first in line). In the case of a transfer from a controlling shareholder, on the other hand, a mandatory exit rule, based on a public offer at the same price, requires the transferor to give up the private benefits of control for a price that does not reflect those advantages. Thus, if private benefits of control are high, the disincentive effect of a mandatory sharing of bid premiums will be significant.¹⁵⁰ Fewer control shifts will occur because not only must the acquirer bid for the whole share capital, but also it is unable to offer the transferor any premium for control (or at least cannot do so without overpaying for the share capital taken as a whole). In countries where controlling shareholders, especially in families, are common, this may be seen as a strong objection to the mandatory bid rule.¹⁵¹ In such cases, 'it is far from certain that the benefits to minority shareholders from protection against value-decreasing acquisitions (in the worst scenario, by looters) are greater than the costs of lost opportunities for value-increasing acquisitions, the increased agency costs of reduced market discipline upon incumbent managers and blockholders, and the efficiency loss deriving from the lesser adaptability of the industrial system to environmental changes.'¹⁵² The adverse impact of the mandatory bid rule is further enhanced if it applies to indirect acquisitions of control.¹⁵³

¹⁵⁰ John C. Coffee, *Regulating the Market for Corporate Control*, 84 COLUMBIA LAW REVIEW 1145, 1282-9 (1984) and L. Bebchuk, *supra* note 124.

¹⁵¹ See Alexander Dyck and Luigi Zingales, *Private Benefits of Control: An International Comparison* 59 JOURNAL OF FINANCE 537 (2004) (sample of 412 control transactions in 39 countries: control premia vary between -4% and 65%); Rolf Sjöög, *Does Sweden Need a MANDATORY BID RULE? A CRITICAL ANALYSIS* (1995) (Sweden in the end did adopt the mandatory bid rule in 1999. As to the reasons for the adoption, see Klaus J. Hopt, *Common Principles of Corporate Governance*, in Joseph McCahery, Piet Moerland, Theo Raaijmakers, and Luc Renneboog (eds.), *CORPORATE GOVERNANCE REGIMES, CONVERGENCE AND DIVERSITY* 175, 180 (2002)). On the other hand, the mandatory bid rule will prevent all inefficient transfers of control, the price demanded by the incumbent controller, when generalized across all the shares, will exceed the current value of the firm, thus preventing inefficient transfers.

¹⁵² Luca Enriques, *The Mandatory Bid Rule in the Proposed EC Takeover Directive: Harmonization as Rent-Seeking?* in Ferrarini et al. (eds.), *supra* note 82, at 785. See further A. Passes, *supra* note 85, at 653f, arguing for the abandonment of the mandatory bid rule and for permitting the acquirer of the controlling block to make a post-acquisition bid at the higher of the pre- and post-acquisition market price of the target's shares. A further consequence of this analysis is that a harmonized rule on mandatory bids within the EU, even if there is complete uniformity in the formulation of the rule across the member states, will in fact produce very different impacts according to whether block-holding is a prevalent form of ownership.

¹⁵³ Sometimes referred to as the 'chain principle', i.e., a person acquiring control of company A also acquires control of company B. Must the acquirer make a general offer to the outside shareholders of company B? Perhaps reflecting the British penchant for wholly-owned subsidiaries, the City Code starts from the presumption that an offer is not required (Rule 9.1, Note 8), German law, as befits its commitment to group law, starts from the opposite presumption but allows the

However, although the above may constitute strong objections to a rule requiring prorata sharing of the premium, it is not necessarily a strong objection to the mandatory bid requirement, if the price may be fixed at a lower level than the price paid for the controlling shares. As we have seen, some systems do allow variations between the price offered to the minority and that paid for the controlling shares or permit partial bids in certain cases.¹⁵⁴ However, other systems are committed to the principle of equality of treatment even in the case of sales of controlling blocks and the Takeovers Directive has made this choice.¹⁵⁵

8.3.2 Facilitating bids for controlled companies

The existence of controlling blocks of shareholders in public companies clearly constitutes a structural barrier to control shifts, if the controllers are unwilling to relinquish their position. However, there is not much company law can do about such barriers—other than refrain from designing rules which, like the full-price mandatory bid, reinforce the reluctance of controllers to sell out. Concentrated patterns of ownership represent ... simply the existing condition of the economic environment.¹⁵⁶ By contrast, 'technical' barriers to control shifts—which constitute part of the formal structure of the corporate governance environment¹⁵⁷—may be susceptible to regulation through corporate law. The recent adoption by the European Community of a Break-Through Rule (BTR) constitutes an example—ultimately only very partially successful—of a legislative attempt to address technical barriers to control shifts.

The break-through rule (BTR), embodied in the directive after a number of versions of it had been canvassed by the Commission's High Level Group of Company Law Experts¹⁵⁸ and in various drafts of the directive, aims to prevent boards and controlling shareholders from structuring the rights of shareholders pre-bid in such a way as to deter bids. Subject to the payment of compensation, it mandatorily removes (some) restrictions on shareholders' transfer and voting rights once a bid is made, whether the restrictions are found in the company's constitution or in contracts among shareholders (to which contracts the company may or may not be party).¹⁵⁹ Restrictions on rights to transfer shares (more likely to found in shareholder agreements than the constitutions of public companies)

supervisory authority to dispense with the obligation if the assets of the subsidiary are less than 20% of the assets of the parent (§ 35 WpUG).

¹⁵⁴ See *supra* 8.2.5.4. However, it is not clear on what basis the discount from the highest price rule has been identified.

¹⁵⁵ Art. 5.

¹⁵⁶ Ronald J Gilson, *The Political Ecology of Takeovers* in Hope and Wymerssch (eds.), *supra* note 49 at 67, discussing the difference between 'structural' and 'technical' barriers to takeovers.

¹⁵⁷ *Ibid.*, p. 65.

¹⁵⁸ Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, Brussels, January 2002 at 28–36.

¹⁵⁹ Art. 11.

are not permitted to operate during the offer period. More important, restrictions on voting rights are not permitted, and multiple voting shares will be reduced to one vote per share, at any shareholder meeting called to approve defensive measures under the 'no frustration' rule¹⁶⁰ and at the first general meeting called by a bidder who has obtained 75% of the capital carrying voting rights. At this meeting any 'extraordinary right' of shareholders in relation to the appointment and removal of directors, contained in the company's constitution, shall not apply either.¹⁶¹ The break-through of voting restrictions during the offer period might be thought to be necessary to make the no frustration rule work effectively. The post-acquisition break-through is potentially more significant and gives the successful bidder an opportunity to translate its control of the share capital into control of the company by placing its nominees on the board and by amending the company's constitution so that its voting power reflects its economic interest in the company. The overall impact of the BTR, if implemented, is to render contestable the control of companies where control has been created through (some) forms of departure from the notion of 'one share one vote' or by shareholder agreements.

However, adoption of the BTR was made optional for member states in the final version of the Takeover Directive.¹⁶² Very few of the member states have adopted the BTR in full, as set out in the directive, apparently only some of the Baltic States,¹⁶³ and a few have opted for partial adoption.¹⁶⁴ Thus, the overall response of the member states has been to take only a very limited interest in introducing a significant version of the BTR into their national systems. In particular, it was rejected by 13 states which nevertheless choose to apply the ban on post-bid defences.¹⁶⁵

Why should this be? First, the BTR does not attack blockholding as such but only situations where the controlling position results from the misalignment of

¹⁶⁰ *Supra* 8.2.2.

¹⁶¹ Thus rights of codetermination (see *infra* 8.5) are not affected because these are normally not shareholder rights of appointment and will be contained in legislation rather than the company's articles.

¹⁶² Art. 12, just as the 'no frustration' rule was made optional.

¹⁶³ Commission Implementation Report 2007, p. 7. One state, Hungary, which previously had a mandatory partial BTR, removed it upon implementation of the Directive. For Italy, which initially adopted the BTR on implementation, see *infra* 8.6.

¹⁶⁴ Thus in France restrictions on the transfer of shares found in the company's constitution (but not those in shareholder agreements) do not apply in relation to a takeover offer (Art. L. 233–34 of the Commercial Code), whilst at the first general meeting after a bid, where the offeror has succeeded in obtaining acceptances from two-thirds of the capital carrying voting rights, voting caps in the articles do not apply (Art. L. 225–125 of the Commercial Code and General Regulation of the AMF, Art. 231–43). In some member states, notably Germany, voting caps have been removed as part of general corporate law reforms, not restricted to takeovers (§ 134 I Aktiengesetz, amendment of 1998, applying to listed companies).

¹⁶⁵ Including the UK, which has traditionally relied on a market, rather than a legal, solution to 'one share, one vote' issue, namely, the reluctance of institutional investors to buy restricted voting shares, unless they are convinced there are good reasons for the restrictions. Davies, *supra* note 41.

control rights and cash-flow rights (or restrictions on transfer) and, even then, only where, the misalignment is sufficient to trigger the BTR's threshold. Thus, a person holding just over 25% of shares of a company which have been issued on a 'one share; one vote' basis would not be affected by the post-bid BTR; nor would a person holding shares carrying just over 25% of the cash-flow rights, even if that person has voting rights which are disproportionately excessive to his cash-flow rights. In consequence, the control position in rather few public companies in the Community was potentially affected by the BTR—but enough to generate aggressive lobbying by those which were.¹⁶⁶ Second, the arguments for and against controlling positions not based on proportionate holdings of control and cash-flow rights were thought to be inconclusive, a deficiency which undermined the later Community initiative towards the imposition of a mandatory 'one share; one vote' rule in public corporations across the board.¹⁶⁷ Third, the limited member state take-up of the BTR could be seen as a response to the inadequacy of the BTR as stated in the directive: it left many pre-bid shareholder structures with defensive qualities in place (non-voting shares, extra voting rights given to long-term holders of shares, preference shares, pyramids, cross-holdings, splitting the holders of the voting and the economic rights in the shares so as to put the former in friendly hands,¹⁶⁸ controlling blocks exceeding 25% of the voting capital). On the other hand, picking up all possible shareholding structures with defensive qualities would lead to an extensive curtailment of the freedom of companies to adopt what they see as appropriate capital arrangements.¹⁶⁹

Even if a member state chooses not to impose the BTR, as most have so chosen, each member state is obliged to permit companies incorporated in its jurisdiction to opt into the BTR.¹⁷⁰ The directive requires opting in and out to be effected in the same way as a change to the company's constitution, i.e., in Europe by

¹⁶⁶ See John C. Coates IV, *The Proposed 'Break-Through' Rule* in Ferrarini *et al.* (eds.), *supra* note 82, Ch. 10, summarizing the available data. These suggested only a maximum of 4% of public firms in the EU would be affected, and the controlling shareholders in some of those might be able to avoid the impact of the BTR by increasing their holdings of cash-flow rights or moving to equivalent structures not caught by the BTR, such as pyramid structures and/or cross-holdings.

¹⁶⁷ Commission of the European Communities, IMPACT ASSESSMENT ON THE PROPORTIONALITY BETWEEN CAPITAL AND CONTROL IN LISTED COMPANIES (Staff Working Document), SEC(2007) 1705.

¹⁶⁸ A technique frequently employed in the Netherlands.

¹⁶⁹ The non-adoption by the UK of the BTR is particularly interesting in this regard. The British government gave as its main reason that 'market forces have reduced the number of companies with differential share structures without legislative intervention.' Department of Trade and Industry, COMPANY LAW IMPLEMENTATION OF THE EUROPEAN DIRECTIVE ON TAKEOVER BIDS, January 2005, para 3.9. This is a reference above all to the attitudes of the institutional shareholders whose opposition to buying non-voting and restricted-voting stock is strong and of long standing. See Davies, *The Regulation of Defensive Tactics in the United Kingdom and the United States* in Hopf and Wymeersch (eds.), *supra* note 49, Ch. 7. The Government was also alive to the desirability of not driving listings out of London. Those companies which had survived this market pressure probably had good reasons for their differential voting structures and so it would be undesirable to impose a BTR on them.

¹⁷⁰ Art. 12.2.

shareholder vote alone. In that decision the voting restrictions and multiple voting rights to which the BTR would apply, if adopted, will still be in force. The incentives for a controlling shareholder to opt in and thus partially dismantle the defences the company has put in place do not seem to be strong. In particular, they will depend substantially on the take-up of a further option given by the Directive to the member states, i.e., whether to permit companies which opt into the BTR to do so on the basis of the 'reciprocity rule'. This permits an opting-in company to do so on the basis that the BTR will not operate in relation to a bid from a company which is not itself subject to the equivalent of the BTR.¹⁷¹

A potential acquirer company, which is already BTR compliant, might choose to opt in, because, as a potential acquirer, it protects itself against a target relying on the reciprocity exception where that option has been taken up in the target company's state of incorporation. The strength of the incentive in this case thus depends upon how many member states (containing potential target companies) permit the reciprocity exception.¹⁷² Even where the potential acquirer is not BTR compliant, it might see some advantage in putting itself in this position, in order to obtain the advantage just indicated. The strength of this incentive is somewhat increased by the fact that opting into the BTR is a reversible decision.

Where the state of incorporation of the company considering opting in has adopted the reciprocity rule, the BTR might generate an additional effect. The reciprocity exception might make the controllers somewhat more willing to comply with pressure from institutional shareholders to opt into the BTR, because the company will be required to do so only on the basis of a level playing field with other companies (whether domestic or foreign). Overall, however, the incentives for companies to opt into the BTR do not look strong.

8.4 Acquisition of Non-Accepting Minorities

The absence, in a control shift, of a corporate decision which binds all the shareholders means that shareholder decision-making under a general offer can operate so as to confer hold-up powers on minority shareholders who do not accept the offer, despite the fact that the majority of the shareholders have chosen to do so. This issue can arise whether the new controller has acquired that position from dispersed shareholders or from an existing controlling shareholder, provided, of course, that it is important to the acquirer to obtain complete control. Minority shareholders may decide not to accept the offer in the hope of negotiating more favorable terms with the acquirer after the bid has closed or because they wish to

¹⁷¹ Art. 12(3). Despite some ambiguity the better view is that the reciprocity option is available when a company opts into the BTR and not only where the member state imposes it.

¹⁷² The Commission's Implementing Report (*supra* note 37) suggests just over half the member states allow reciprocity.

maintain their opposition to the control shift or they may simply have failed to respond to the offer. Most jurisdictions provide, in one way or another, for the squeeze-out of minorities on the terms accepted by the majority, but only where a very high proportion of the shareholders have accepted the offer. Even more significant, the squeeze-out right facilitates the initial fixing of the level of the offer at less than the post-acquisition price of the shares. It achieves this result by eliminating the free-rider incentives of target shareholders, which the acquirer may otherwise be able to counter only by equating the offer with the post-acquisition price of the shares, thus reducing the acquirer's incentive to bid at all.¹⁷³

In most jurisdictions, minority hold-ups or incentives not to tender are directly addressed by rules which give the acquirer compulsory purchase powers over the non-accepting minority.¹⁷⁴ In Delaware the acquisition is effected through the short-form squeeze-out merger available to the holder of 90% of each class of stock in a Delaware corporation and without, in principle, a review by the courts of the fairness of the merger.¹⁷⁵ The importance of the squeeze-out to acquirers is reflected in the way in which control of access to the short-form merger is used as a takeover control device in Delaware.¹⁷⁶

The squeeze-out mechanism may be specific to control shifts, in which case the issue of price can be settled by entitling those whose shares are compulsorily acquired to the same consideration as was offered in the general offer. Where the squeeze-out mechanism is general (i.e., permitting a large majority shareholder to acquire compulsorily the remaining shares, no matter whether the majority was acquired in a bid), the rules for fixing the price may be more contestable.¹⁷⁷ However, the compulsory buy-out threshold, whether the mechanism is specific or general, is set at a high level, normally the 90% or 95% level.¹⁷⁸ Control shifts

¹⁷³ Burkhardt and Panunzi, in Ferrarini, *supra* note 82, at 753-6.

¹⁷⁴ The Takeover Directive (Art. 15) requires member states to provide such a mechanism and some half a dozen states (mainly small but including Spain) introduced it in consequence: Commission Report, *supra* note 37 at 9.

¹⁷⁵ DGCI § 253. And see *supra* 7.4.2.

¹⁷⁶ Delaware's statutory 'anti-takeover' provision relies precisely on restricting access to business combinations (especially the short-form squeeze-out merger) between a bidder and the target in the three years after the acquisition of control: § 203 DGCL. These restrictions can be avoided if there has been either approval by the previous board of the target or a high level of acceptance (85%) of the offer by the target shareholders. See generally Y. Amihud, M. Kahan, and R. Sundaram, *The Foundations of Freeze-out Laws in Takeovers* 59 JOURNAL OF FINANCE 1325 (2004).

¹⁷⁷ Some jurisdictions have both types of rule. In Germany the introduction of the squeeze-out power specific to control shifts was important precisely because of its presumption that the bid price is fair (§ 39a(3) WpÜG), in contrast to endless opportunities to challenge the price under the general merger procedure (§ 327b AktG). Under both specific and general squeeze-out mechanisms the courts are likely to be worried if the threshold is (to be) reached as a result of a bid by an already controlling shareholder. See *Re Bugla Press* [1961] Ch 279, CA (UK) and *Re Pure Resources Inc* 808 A.2d 421 (Del. Ch. 2002)—both in effect requiring the acquirer to show the offer to be fair.

¹⁷⁸ However, it is important to see whether this is a percentage of the shares offered for or a percentage of the issued shares of the class. In the former case, shares held by the offeror before the bid do not count.

might be facilitated by setting the squeeze-out threshold lower. In fact, one of the attractions of using the statutory merger procedure¹⁷⁹ to effect a control shift, rather than deploying it as a tidying-up mechanism after a high threshold of ownership has been achieved through a general offer, is that complete control of the target is achieved at a lower level of acceptances from the shareholders than that needed to trigger a post-bid squeeze-out. The decision of the shareholders, acting as the company, makes the statutory merger binding on all the shareholders (perhaps subject to court approval or appeal to the court)¹⁸⁰ at a consent level of something like two-thirds or three-quarters of those voting at the meeting.

In many countries the right of the offeror at the 90%-plus level to acquire minority shares compulsorily is 'balanced' by the right of minorities to be bought out at that level, a right which, again, may be tied to a preceding takeover offer or not.¹⁸¹ However, functionally, the two are very different. Within control transactions, the effect of a right to be bought out is to reduce the pressure on target shareholders to tender, though that objective is in fact better achieved by rules requiring the bid to be kept open for a period after it has become unconditional, because the latter rule is not linked to any particular level of acceptances.¹⁸²

8.5 Agency Problems of Non-Shareholder Groups

Some have argued that a substantial proportion of the gains to acquirers from takeovers are the result of wealth transfers from non-shareholder groups, especially the employees of the target.¹⁸³ The responses of control transaction regulation to this issue can be put, broadly, into one of three classes. First, those systems which allocate to the shareholders of the target the exclusive power to approve the offer find it difficult to fit into that structure a significant mechanism for the protection of non-shareholder interests, other than via disclosure of

¹⁷⁹ *Supra* 8.1.1. British courts have treated the acquirer as having a free hand to structure the deal as a take-over or a merger (and even to change horses in the middle of a transaction) on the grounds that court approval in a merger is a substitute for the high level of acceptances required for the squeeze-out: *Re National Bank* [1966] 1 WENDEY LAW REPORTS 819.

¹⁸⁰ Other squeeze-out techniques may be available to the acquirer at a lower level of acceptances for example, delisting the company's shares. See *supra* 7.4.2.3.2.

¹⁸¹ Both types of rule are discussed in greater detail in Forum Europaeum Corporate Group Law, *Corporate Group Law for Europe*, I EUROPEAN BUSINESS ORGANISATION LAW REVIEW 165, 226 et seq. (2000). The Takeover Directive requires both a squeeze-out and a sell-out right.

¹⁸² See *supra* 8.2.5.4. An offeror may be satisfied with a controlling stake short of the 90% level and thus not be subject to the sell-out right, whereas the 'keep it open' requirement applies at whatever level the acquirer declares the bid to be unconditional.

¹⁸³ Margaret M. Blair, OWNERSHIP AND CONTROL (1995); Andrei Shleifer and Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in Alan J. Auerbach (ed.), CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33 (1988).

information.¹⁸⁴ This strategy is heavily adopted by the Takeover Directive,¹⁸⁵ but the disclosure obligation sits in a vacuum, dependent for its effectiveness upon rules and institutions existing outside corporate law. In some jurisdictions such structures—usually some form of works council—do exist and may be built into the takeover process by national legislation.¹⁸⁶

Where, however, the board is given a significant role in the takeover process, a second pattern can be discerned, which is to regard the survival of target management as a proxy for the furtherance of the interests of non-shareholder groups. Thus, in the U.S., one popular form of state anti-takeover statute ('constituency statutes') consists of expanding widely the range of interests beyond the shareholders' interests which management is entitled (but not bound) to take into account when responding to a takeover bid.¹⁸⁷ It is doubtful, however, whether, by itself, relieving directors of liability to the shareholders if they act to promote non-shareholder interests encourages anything more than self-interested behavior on the part of the target board. The greater the range of interests which directors are entitled to take into account when exercising their discretion, the more difficult it will be to demonstrate in any particular case that the standard has been breached. If this is a correct analysis, non-shareholder constituencies will benefit from such rules only to the extent that their interests happen to coincide with those of the target board.¹⁸⁸

The third pattern involves taking the step of giving the non-shareholders a decision-making role, though it is a pattern to be found in practice only in relation to employee interests. In those jurisdictions (notably Germany) in which company law is used in a significant way to regulate the process of contracting

¹⁸⁴ Of course, non-shareholder interests may be protected through mechanisms existing outside company law which deal with some of the possible consequences of a control shift, for example, mandatory consultation over lay-off, under Council Directive 98/59/EC on collective dismissals. See *supra* 7.4.3.2.

¹⁸⁵ The extent to which the employees should be informed or be influential in the takeover process was one of the contentious issues in the deadlock over the Commission's Proposal for a Takeover Directive. The Parliament's attempt to ride all possible horses can be seen in one of its proposed amendments to the effect that 'the board of the offeree is to act in the interests of the company as a whole, in particular in the interests of corporate policy and its constitution, shareholders and staff, and with a view to safeguarding jobs, and must not deny the holders of securities the opportunity to decide on the merits of the bid.' As enacted the directive requires the target board to act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid.

¹⁸⁶ Thus, French law (Code du Travail, Art. L. 432-1) requires an immediate meeting between the CEO of the target and the works council when the bid becomes public and, if requested by the works council, a second meeting within fifteen days of the publication of the offer document, which a representative of the acquirer must attend. Non-compliance may result in the target's shares acquired by the bidder losing their voting rights. For an analysis of the potential of such mechanisms for employee involvement in the decision-making on control shifts see Final Report of the Project Agire (2008), available at <http://www.ife-agire.com/>.

¹⁸⁷ See, e.g., § 717(b) New York Business Corporation Law.

¹⁸⁸ See also Mark J. Roe, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE 45 (2002) (employee influence is indirect and weak, constituency laws are made by and for managers).

for labor,¹⁸⁹ the presence of employee representatives on the supervisory board and the relative insulation of the board from the direct influence of the shareholders may enable those representatives to have a significant input into takeover decisions (perhaps to the point where control shifts which are unacceptable to the employee representatives are hard to achieve). This strategy depends upon the law adopting a model of joint board/shareholder decision-making over the bid. Moreover, in this situation the disclosure requirements of takeover laws and general corporate law provisions defining 'the company' so as to include non-shareholder interests operate in an entirely different institutional context and may have real bite.¹⁹⁰

In jurisdictions in which decision-making is placed in the hands of the shareholders exclusively, ad hoc examples of significant employee influence may be found, usually in relation to the acquirer's willingness to offer. Thus, in the UK, the new-found and still ill-defined rights of the Pensions Regulator¹⁹¹ and by extension the trustees of employee pension schemes, which are in deficit, to require a new owner of the company to make substantial contributions to the fund, especially if it is proposing to make significant alterations to the risk profile of the company's business (likely if a private equity bid is in question), has been an important factor in a number of recent proposed bids either not emerging or emerging on terms more favorable to the employees. Equally, a generally disorderly industrial relations climate in a particular company may discourage bidders from emerging: the potential acquirer may not think it can solve all the difficult problems of the target company which the present owners have singularly failed to address.

8.6 Explaining Differences in the Regulation of Control Transaction

We have analysed control shift regulation along two main and one minor dimension. The major dimensions were the location of decision-making on the offer and the protection of target shareholders (especially non-controlling shareholders) against opportunism on the part of the acquirer or target management. The minor dimension was the responsiveness of the regulation to non-shareholder constituencies.

Two immediate conclusions can be drawn from our analysis. The first and negative conclusion is that none of the systems puts the goal of maximizing the number of control shifts at the centre of their regulatory structures. The maximum

¹⁸⁹ See *supra* 4.1.1.

¹⁹⁰ For information provisions in Germany see § 11(2) *Übernahmegesetz* and § 2 *Übernahmegesetz*-Angebotserforderung (Germany). For the inclusive definition of the interests to be considered in Germany, see Michael Kort, N852-78 § 76, in Klaus J. Hopt and Herbert Wiemann (eds.), *GROSS-KOMMENTAR ZUM AKTIENGESETZ* (4th ed., 2003).

¹⁹¹ Under the Pensions Act 2004.

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

The second is that there are important tradeoffs involved in the placing of a particular system along the three (two major, one minor) dimensions. Thus, provisions aimed, at least ostensibly, at protecting target shareholders, may operate indirectly so as to protect target management.¹⁹² A system which rigorously controls defensive tactics on the part of management may nevertheless still chill takeovers by, say, strict insistence upon equality of treatment of the target shareholders by the acquirer or the prohibition of partial bids. Indeed, it is probably no accident that those systems which, historically, most clearly favor shareholder decision-making in bid contexts (France, UK) also have the most developed rules protecting target shareholders against acquirer opportunism. Deprived of the protection of centralized management, the target shareholders need explicit regulatory intervention as against acquirers, but that intervention—notably the mandatory bid rule—may also protect indirectly incumbent management. Thus, comprehensive control shift regulation of the type found in the UK may both make it difficult for incumbent management to entrench themselves against tender offers which do emerge and reduce the incidence of such offers. Which effect is predominant in practice is an empirical question.¹⁹³

It is clear that the most sensitive question in relation to control transactions is whether they can be implemented over the opposition of the incumbent board. The hostile takeover dramatizes the conflict between shareholders and managers (and other stakeholders) in a more effective way than any other corporate event. Facilitating or hindering hostile takeovers thus often becomes the central issue in debates over whose interests the boards of companies are required to promote. In tussles between shareholders and managers over the design of takeover legislation, the management often strands as proxy for the interests of the employees and of local communities and perhaps even of the national economy.

So, the crucial dividing line might seem to be between those systems which place the decision on the control transaction wholly in the hands of the target shareholders and those which give to each of the target shareholders and target

¹⁹² See also Sanford J. Grossman and Oliver Hart, *An Analysis of the Principal-Agent Problem*, 51

ECONOMETRICA 7 (1983).

¹⁹³ Martynova and Renneboog *supra* note 32 show that in the European merger wave of the 1990s 58% of all hostile takeovers within Europe (29 countries) involved UK or Irish targets as did 68% of all tender offers (hostile or friendly) (Table 4), whilst the takeover premium paid for UK targets 'towered above' that paid for Continental targets (Figure 23).

board a veto over the transaction. This is the major fault-line in the design of control-shift rules. However, there are reasons for thinking that this division may be an over-simplification. First, it is possible, though not straightforward, for a jurisdiction which allocates the decision on the control shift jointly to target shareholders and target boards to develop adaptive mechanisms which, to a greater or lesser extent, reproduce the effects of an allocation wholly to the shareholders of the target company. As we have seen,¹⁹⁴ the U.S. demonstrates the possibilities for a development of this kind. Thus, Armour and Steel have argued that, whilst the proportion of hostile bids in the U.S. is smaller than in the UK,¹⁹⁵ which allocates the decision entirely to the shareholders, the overall level of control shifts is not much different.¹⁹⁶ This suggests that the strategies for controlling the exercise by incumbent management of their decision rights over the control shift have had the effect of moving the U.S. towards the UK position. In other words, a combination of legal strategies and institutional facts may permit the shareholders to reap the benefits of joint decision-making over control shifts (shareholders overcome their coordination problems by using management to negotiate with the bidder on their behalf) without incurring the costs of this arrangement (notably management entrenchment). Where those legal strategies are not available or the institutional facts do not obtain, however, the initial allocation of the decision right will indeed be crucial.

One may wonder why the UK and the U.S. have taken such different doctrinal paths to achieve an arguably similar result. Doctrinal path-dependency would seem to explain a lot here. The UK system of company law has always been strongly shareholder-centred—the board's powers derive from the company's constitution, not the legislation, and the constitution is, formally, wholly under the control of the shareholders;¹⁹⁷ and directors can be removed at any time by ordinary shareholder vote—whilst U.S. law has been more protective of the prerogatives of centralized management,¹⁹⁸ whilst preserving the ultimate control of the shareholders.¹⁹⁹ For the UK, allocating decision-making on control shifts wholly to the shareholders fitted well with established patterns of corporate governance, whilst in the U.S. shareholder influence over control shifts was established in a more convoluted and, perhaps, less stable way, but one doctrinally consistent with its managerial orientation.²⁰⁰

¹⁹⁴ See *supra* 8.2.3.1.

¹⁹⁵ Armour and Steel, *supra* note 30, Table 1.

¹⁹⁶ *Ibid.*, p. 16. Whether the two systems are functionally absolutely equivalent is not clear (see

Armour and Steel, *supra* note 30 at 1742–3, arguing that the U.S. system has costs which the straightforward adoption of a no frustration rule avoids).

¹⁹⁷ *Supra* 7.2.

¹⁹⁸ *Supra* 3.1.3.

¹⁹⁹ *Supra* 3.7.

²⁰⁰ Armour and Steel, *supra* note 30 at 1767–8 point out that the traditional doctrinal pro-shareholder orientation of British corporate law was reinforced by the rise of institutional shareholding during the precise period that modern takeover regulation was being developed in the UK, i.e., in the 1960s, whereas this coincidence did not occur in the U.S. Equally, one might speculate that, if managerial stock option plans were to become a less significant part of compensation in the U.S., then U.S. institutional investors might begin to agitate for shareholder-friendly control-shift regulation.

There is a further, and very different but important, sense in which the initial allocation of decision rights is less important than it might seem. In jurisdictions where corporate control is typically concentrated in the hands of blockholders, the notion of a hostile takeover (one accepted by the shareholders over the opposition of the incumbent board) seems beside the point, since the directors in all likelihood will be the nominees of the controlling shareholder (except to the extent that employees have appointment rights). Yet, blockholding regimes dominate the international landscape, with dispersed or semi-dispersed shareholding patterns being the exception.²⁰¹ However, here too some qualification is called for. The average size of the largest block varies from jurisdiction to jurisdiction,²⁰² so that in jurisdictions with smaller average blocks, whilst hostile takeovers may be more difficult, they are not ruled out entirely. Further, there is evidence, in important jurisdictions, of a weakening of the grip of blockholders.²⁰³ Finally, even in jurisdictions dominated by large blockholders, shareholdings in particular companies atypically may be dispersed. Thus, there are very few jurisdictions in which hostile takeovers are fully ruled out on shareholder structure grounds. More important, over the last decade the hostile bid has become a significant event in a number of jurisdictions where previously it was virtually unknown.²⁰⁴

Again, the desire of rule-makers to fit regulation of the hostile takeover into the existing parameters of corporate law explains much of the responses in these jurisdictions. In the European Community the legislative response was crystallized around the design and implementation of the Takeover Directive, with the European Commission pushing for a liberal response as an important tool for promoting an integrated 'single market' within the Community,²⁰⁵ whilst some

²⁰¹ M. Becht and C. Mayer, *Introduction* in F. Barca and M. Becht (eds.), *THE CONTROL OF CORPORATE EUROPE* (2001).

²⁰² *Ibid.*, Table 1.1, reporting that in the late 1990s the median size of the largest voting block in listed companies varied from 57% in Germany to 20% in France.

²⁰³ Franks, Meyer, Volpin, and Wagner, *Evolution of Family Capitalism: A Comparative Study of France, Germany, Italy and the UK* (<http://ssrn.com/abstract=1102475>) p. 13 and Table 2, showing an increase in the proportion of widely held listed companies between 1996 and 2006 (from 21% to 48% in Germany; from 16% to 37% in France; and from 19% to 22% in Italy; the UK figures were 91% in both years). 'Widely held' is defined as a company where the largest vote-holder had less than 25% of the voting rights—a relatively generous definition of 'widely held'. For Japan see Tokyo Stock Exchange, *SHARE OWNERSHIP SURVEY* (2007). See also Marynova and Rennboog *supra* note 193, Table 4 showing that 42% of European hostile takeovers in the 1990s occurred outside the UK and Ireland, notably in France, Sweden, and Norway.

²⁰⁴ Franks *et al.*, *supra* note 202, Appendix A.3 report that the average number of listed companies which were the target of an unsolicited bid expressed as a percentage of all listed companies increased between the periods 1992–1996 and 2002–2006 from 0% to 0.19% in Germany; from 0% to 0.22% in Italy; and from 0.03% to 0.15% in France. The UK figures were 0.18% and 0.93%. It must be remembered, however, that the proportion of the largest 1000 companies (by sales) which is listed in those three jurisdictions is smaller than in the UK (in the UK about half; in the other countries between 15% and 30%). The same general trend can be found in Japan, as the litigation it has generated attests. See *supra* note 42.

²⁰⁵ For which policy there was considerable empirical support. See, for example, Marynova and Rennboog, *supra* note 32 at 4 stating that the European merger boom of the 1990s 'boiled down to business expansion in order to address the challenges of the European market'.

member states (and the European Parliament) responded to current popular fears of globalization and its impact.²⁰⁶ With the abandonment of the 'no frustration' and 'break-through' rules as mandatory rules at Community level,²⁰⁷ the protectionist forces may be said to have had the better of the argument with the liberals at Community level. This trend was repeated in the transposition of the directive, where, overall, there was a less liberal approach on the part of the member states than had obtained previously.²⁰⁸

Turning to specific national level actions, German opposition to the hostile bid can be said to reflect the general weakness of shareholder interests in that traditionally bank-financed economy,²⁰⁹ whilst the protection of employee interests within and outside the corporate structure (through various forms of codetermination) is perceived in that country as a particularly important way of securing social cohesion, which might be undermined by control shifts decided on solely by shareholders. In any event, after the successful hostile takeover of Mannesman, a German company with, unusually, a fairly dispersed shareholding body, by Vodafone, a British one, and the fear of such a takeover of the national champion, Volkswagen, the German government mobilized its resources to defeat at the last moment in the European Parliament the draft Takeovers Directive which, in its then form, would have made the 'no frustration' rule mandatory and which had previously been approved by all the member states, including Germany.²¹⁰ This permitted the government to proceed with its strategy of allocating approval of defensive measures to the supervisory board, on which in the largest companies the employees hold half the seats.²¹¹

²⁰⁶ See Hopf, *supra* note 40 at III.A on the spread of economic nationalism within the Community.

²⁰⁷ *Supra* 8.2.2 and 8.3.2.

²⁰⁸ Commission Report, *supra* note 37, p. 6. Transposition of the Directive was taken as the opportunity in some member states to qualify an existing 'no frustration' rule, usually through adoption of the reciprocity exception. Only one member state previously without a 'no frustration' rule adopted it upon implementation of the directive. Nevertheless, the overwhelming majority of member states have the 'no frustration' rule and had adopted it before the Directive was passed, probably in anticipation of the directive's adoption of it as a mandatory rule. As pointed out above in this section, however, the significance of this statistic is somewhat undercut by the presence of controlling blockholders in most member states.

²⁰⁹ Of course, the extensive reforms from the 1990s onwards, under the general rubric of promoting *Finanzplatz Deutschland*, have altered this traditional bank orientation considerably but the hostile takeover tests the limits of the reform movement. See A. Börsch, *GLOBAL PRESSURE, NATIONAL SYSTEM* (2007) Ch. 3.

²¹⁰ Hopf, *supra* note 40, at III.A.b. See also the heated discussion of 'shareholder activism' in the Netherlands in the wake of the pressure exerted on the board by the shareholders of the Dutch bank, ABN-Amro, to put the business up for sale—a step which led to a prolonged battle between rival takeover consortia led by the British banks, Barclays, and the Royal Bank of Scotland in 2007. See also *supra* note 75.

²¹¹ See *supra* 8.2.3.3. Note that even where the power to take defensive measures has been conferred on the management board in advance by the shareholders, supervisory board approval of the exercise of that power is required, so that the employee representatives will have an input into that decision by the management board.

In France, which has a longer, if low-level, exposure to hostile takeovers and to their regulation,²¹² the response to the increase in hostile takeover offers was more muted. The 'no frustration' rule was confirmed in the implementation of the directive, subject to the possibility of adopting defensive warrants against acquirers not subject to that rule.²¹³ In France employee representation within the corporate structure is a much less significant policy goal than in Germany.²¹⁴ France has traditionally relied more on state than managerial action to protect non-shareholder interests in the company.²¹⁵ In consequence, such protection has traditionally been delivered outside the framework of rules regulating agency and coordination issues between the parties in control shifts. Thus, at the same time as the Takeover Directive was being implemented in France, the foreign investment rules were strengthened so as to expand the areas of the economy in which non-EU acquirers could obtain control only with the consent of the French state.²¹⁶

Finally, Italy is difficult to read. Having initially adopted, unusually among the member states, both the 'no frustration' and the 'breakthrough' rules, it reversed both decisions in late 2008, apparently in response to fears of the takeover of Italian 'national champions' by foreign companies and sovereign wealth funds in the wake of the 'credit crunch' of 2008.²¹⁷

²¹² Explicit regulation of takeovers in France dates from the late 1960s, as in the UK. See Vandier, *OPA, OPE ET AUTRES OFFRES PUBLIQUES* (3rd ed., 2006), paras. 71ff.

²¹³ See *supra* 8.2.3.

²¹⁴ See *supra* 4.2.1.

²¹⁵ Vivien A Schmidt, *THE FUTURES OF EUROPEAN CAPITALISM* (2002) at 117–18. See also Martyrova and Rennboog *supra* note 32 at n. 1: 'It is believed that French and Italian governments are rather successful in protecting their national champions. In these countries, hostile cross-border acquisitions hardly ever succeeded in the 1990s. The French and Italian governments encouraged (often inefficient) mergers between national firms to create larger national corporations...'

²¹⁶ See Decree No. 2005–1739 made under Art. L. 151–3 of the Monetary and Financial Code, requiring state approval for acquisitions in areas affecting 'public order, public safety and national defence' but interpreted widely so as to include gaming and private security provision. More generally in France, the state maintains controlling stakes, either directly or indirectly, in industries seen as important for the development of the French economy, so that in these areas a 'French solution' to a mooted control shift is normally implemented. Of course, France is not alone in taking such steps. In the United States, particular control shifts have generated strong opposition in Congress (such as the acquisition of the rights to manage major ports by a Dubai-based company) whilst the Foreign Investment and National Security Act 2007 somewhat extended Congressional control over control shifts in industries thought to have national security implications. Even in the traditionally liberal UK the government exercises a strong influence over control shifts in the defence industry (where it is a substantial customer).

²¹⁷ For the initial Italian implementation see Legislative Decree 19 November 2007, no. 229; and for the revised implementation Decree-Law 29 November 2008, no. 185, Art. 13. In effect, the boards of Italian public companies are free to adopt defensive measures, both pre- and post-bid, unless the company in its constitution has opted into either or both of the 'no frustration' or 'breakthrough' rules. In view of the fact that Italy had initially implemented both rules on the basis of reciprocity (see *supra* 8.3.2) it is doubtful whether this change was needed to provide protection against bids from most foreign companies and sovereign wealth funds.

Particularly intriguing in this context is the case of Japan, which has only recently become a jurisdiction in which hostile takeovers are feasible and which is currently seeking an appropriate set of rules to govern them, being fully aware of the regulatory patterns adopted in other countries. Thus, the Report of the quasi-official Corporate Value Group (2008) adopted a shareholder value line but did not equate this wholly with exclusive shareholder decision-making on defensive measures.²¹⁸ The ultimate shape of Japanese takeover legislation remains to be seen.

Given the range of potential opponents to a shareholder-centred regime of control-shift regulation—management, employees, some versions of national economic policy—it is perhaps surprising that the policy of allocating the decision on the control shift wholly to the shareholders of the target company has been adopted in any jurisdiction. The UK has done so since the introduction of formal regulation in this area in the late 1960s and the rule, although subject to academic criticism, is little contested in debates on public policy.²¹⁹ Elsewhere, the position is more contested. The principle of shareholder decision-making was widely adopted in the EU (outside Germany) in the years running up to the adoption of the Takeover Directive, but, ironically, there has been some retreat from this position in the actual implementation of the directive.²²⁰ In the U.S. assessment of the overall effect of the rules varies with the attitudes of the courts, the development of executive compensation schemes and the willingness of shareholders to be active in opposing staggered boards. Japan is still making up its mind in this area. Looking at control shift rules, more broadly, however, there seems to be general agreement on the need to address shareholders' coordination problems through equality rules of greater or less rigour;²²¹ on the need for extensive disclosure of information from both acquirer and target management (the latter being especially important where the control shift is being promoted by the incumbent management);²²² and on the need to facilitate squeeze outs once an acquirer has obtained an overwhelming level of control.²²³

²¹⁸ Corporate Value Study Group, *TAKEOVER DEFENSE MEASURES IN THE LIGHT OF RECENT ENVIRONMENTAL CHANGES*, June 2008. The Group accepts (1) that in 'obviously detrimental' bids (which concept it tries to limit) the board may unilaterally take defensive measures and (2) that even where this is not the case the board may implement defensive measures provided these are reasonable and proportionate. Shareholder approval is an important but not conclusive factor in whether defensive measures are lawful in this case. This qualification seems partly aimed at protecting minority shareholders, but it also implies that defensive measures in this second category might be lawful even if shareholders have not approved them and even if there were evidence that the shareholders did not approve them.

²¹⁹ Department of Trade and Industry, *IMPLEMENTATION OF THE EUROPEAN DIRECTIVE ON TAKEOVER BIDS*, January 2005, para. 3.6.

²²⁰ See *supra* note 37. ²²¹ *Supra* 8.2.5.3.

²²² *Supra* 8.2.5.1. ²²³ *Supra* 8.3.2.1.