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The Board Neutrality and Breakthrough Rules in the European Union - A Case for Reform

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The Master of Jurisprudence Thesis

Durham Law School

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Introduction

The purpose of this thesis is to analyse the board neutrality and breakthrough rules found in Articles 9 and 11 respectively of the European Takeover Bids Directive, 2004 / 25 / EC. These Articles regulating takeover defences throughout the Member States constituted the most contentious part of the Directive and ultimately resulted in a political compromise - both rules were rendered optional by Article 12. There is a rich and ongoing debate on the regulation of takeovers into which these rules fall and this thesis shall attempt to put forth an argument which supports reform of Articles 9 and 11. This argument will be formed by adopting a multi-method approach, which marries historical context with economic theory, comparative analysis and empirical data. In doing so, it is hoped that this thesis will help contribute to the topic.

It is structured as five chapters. The first of these looks at the history and the difficult path to adoption that the Directive took, framing the Directive within the political-economy landscape. The second chapter looks at the economic theory and empirical evidence on the wealth-effects of takeovers, to act as a foundation for arguments for reform based on economic efficiency which are presented later. Chapters 3 and 4 analyse the board neutrality and breakthrough rules in detail. Their practical operation is discussed and the system of options they provide at the Member State and company levels is explained. These chapters also evaluate the success of these rules in line with the Commission's stated objectives and examine the implementation by the Member States. Finally the fifth chapter draws together the economic analysis and the analysis of the rules' application in order to suggest reforms which, in the author's opinion, would represent a positive advancement of EU takeover law.

Chapter 1 – History, Adoption and Transposition of the Directive

1.1 History of the Directive

The substantive problems of regulating takeovers are numerous and complex, creating a great body of academic work. The possible solutions are far from agreed upon, both in the academic community and in practice.¹ The fact it took 30 years of legal and political process, characterised by setbacks, frustration and compromise, before a watered-down version of the Takeover Directive was formally adopted into European law in April 2004, is a testament to the difficulty faced by law-makers in this field.

Where hostile takeovers are concerned, Professor Hopt rightly argues that globalisation does not respect traditional State boundaries or national law-making. Further, it 'jeopardises venerated national and legal traditions' which in combination with the ability to acquire corporate control via hostile means, can 'threaten even the largest enterprises, some of which, like Volkswagen, are national symbols;² and even loosen the grip of national governments on key industries'.³ Thus, where national interests are at stake, one should be mindful that any takeover regulation must balance the divergent interests of the Member States on the one hand with the aim of achieving an integrated internal market on the other. Attempting to create a level playing field while satisfying Member States with diverse market economies, corporate governance structures, philosophies and cultures would almost inevitably leave some feeling victimised by having to apply a regime that seems more suited to another States' economy than their own. The Directive sought to achieve this balance through compromise, the result of which was the highly controversial Article 12 of the Directive. This Article, among other things, gave Member States the right to choose not to apply two of the key provisions of the directive, namely the board neutrality rule (BNR) in Article 9 and the breakthrough rule (BTR) in Article 11, which this thesis will consider in chapters 3 and 4 respectively.

Nevertheless, it was this difficulty in finding a balance between national interests and achieving an integrated market which has been responsible for the difficulties over the

¹ K. Hopt, 'Takeover regulation in Europe - The Battle for the 13th directive on takeovers' (2002) 15 Aust JCL 1, p3.

² See the Volkswagen Act 1960, later amended in 2008. Lower Saxony holds a 20% stake and the law requires important decisions require an 80% majority, allowing the State to block any decision which needs shareholder approval.

³ *Ibid* 1 at p3.

years.⁴ The events that led up to the adoption of the Takeover Directive will now be considered.

The Initial Proposal

The first attempts to create a takeover regime in Europe were started over 30 years ago, when the Commission asked Professor Pennington to write a report on takeovers in Europe. He presented his report to the Commission in November 1974,⁵ which also included a draft directive, largely modelled on the UK Takeover Code. Years passed without progress however and the Pennington recommendations were abandoned, with the Member States showing a considerable lack of interest.⁶

For a decade there was a period of relatively little interest in a European takeover regime.⁷ Then in 1985, in its White Paper on completing the internal market, the Commission announced its intention to propose a directive on the approximation of Member States' law on takeover bids.⁸ The first draft of the proposal was completed in 1987, however it came under widespread criticism and for a brief period it looked as if the Commission's plans would come to nothing.

But takeover regulation is a politically and economically sensitive area, and events were unfolding in Europe which would rapidly rekindle the Member States' interest, altering their political receptiveness to reform almost overnight.⁹ In January 1988, Italian financier Carlo de Benedetti extended a bid to acquire the controlling share of Société Générale de Belgique, initiating one of Europe's most controversial takeover battles of the decade. The corporate giant controlled over 1,300 companies worldwide and was estimated to have assets valued at approximately one-third of Belgium's total economy.¹⁰

Though ultimately unsuccessful, Benedetti's bid created tremors which galvanised the European Parliament's interest in a takeover bids directive. As a result the Commission published a completed proposal for the directive on 19th January 1988.¹¹ Takeover

⁴ Jonathan Mukwiri, *Takeovers and the European Legal Framework: A British Perspective*, (Routledge 2009) at p9.

⁵ European Commission, 'Report on Takeover Offers and Other Offers', Document XI/56/74.

⁶ *Ibid* 4 at p9.

⁷ However the Commission did issue guidelines in 1977 based on the Pennington recommendations. See European Commission, 'Recommendation of the European Community Commission of 25 July 1977 concerning a European Code of Conduct relating to Transactions in Transferable Securities' OJEC No. L212/37 of 20 August 1977.

⁸ High Level Group of Company Law Experts, *Report on Issues Related to Takeover Bids*, Brussels 10 January 2002 at p13.

⁹ Rolf Skog, 'The takeover directive - an endless saga?' *European Business Law review*, 13 (2002) 304.

¹⁰ *Ibid*.

¹¹ *Ibid* 1 at p9.

regulation was now on firmly on the agenda. After then receiving the opinions of the Economic and Social Committee and the European Parliament, the Commission presented an amended proposal in September 1990.

The second attempt drew concern from multiple angles. One aspect which concerned Germany in particular was the mandatory bid rule and the restriction of defences available to the board of the target company. One might have expected the proposal to have been met with approval from the UK, especially considering the proposal was actually the result of UK initiatives to break down the considerable barriers to hostile takeovers which existed in Germany, the Netherlands and other continental European countries.¹² These barriers sat in contrast to the UK market, which was relatively open to changes in corporate control. German companies such as Siemens for example, were in a position to successfully bid for UK companies,¹³ while UK companies would have no similar chance of acquiring German companies via a hostile bid.¹⁴

Yet still the UK was not satisfied with the proposed Directive. They sought to minimise litigation, preferring self-regulation via Code and Takeover Panel to the EU's tendency to regulate legally. The concern was that a lack of provisions preventing tactical litigation, would cause an excessive amount of frivolous litigation for the supervisory body.¹⁵

Based on this opposition, in its declaration to the European Council in Edinburgh in 1992, the commission announced it would revise its proposal based on the grounds of subsidiarity. Recognising it needed to respond to the concerns of the Member States, the Commission launched a consultation with them, aimed at identifying the issues which could be included in a revised proposal for a Takeover Bids Directive.¹⁶

The Revised Proposal

Following the consultation with the Member States, the Commission tried again in 1996, this time submitting the new proposal in a dramatically diluted form as a framework directive.¹⁷ In the consultation the Member States had shown a clear preference for a document that would only contain the general principles for a takeover bid, leaving considerable scope for the

¹² Ibid 1 at p9.

¹³ In 1988 Siemens launched a successful £1.7bn hostile takeover of Plessey plc.

¹⁴ Though see the later section on Vodafone's acquisition of Mannesmann in 2000, the first successful takeover of its scale.

¹⁵ Jonathan Mukwiri, *Takeovers and the European Legal Framework: A British Perspective*, (Routledge 2009) p11 and ch2. Though some academics have questioned whether the original text posed a genuine threat.

¹⁶ Ibid 8 at p13.

¹⁷ Ibid 1 at p9.

Member States and the competent authorities to deal with the details of implementing those principles.¹⁸ For example, unlike the 1989 version, the 1996 proposal no longer contained a defined EU-wide threshold for the mandatory bid rule, instead leaving it up to the Member States to decide the percentage which would trigger a mandatory bid in their own jurisdiction.

Both the Economic and Social Committee and the European Parliament endorsed this new proposal, though the latter did request minor amendments, resulting in the Commission presenting an amended proposal at the end of 1997. Following further debate, a 'Common Position' was eventually adopted by the Council on 19th June 2000.

The Common Position

Following the adoption of a common position by the Council, the proposal was submitted to Parliament for a second reading. Yet still there were concerns from Parliament. In particular, some Member States were not happy with the BNR. Here the divergent corporate governance structures between the Member States and even more so between Europe and the US showed the problems caused by the lack of a level playing field. Enterprises in the US and in some of the Member States relied on pre-bid mechanisms and structures designed to shield them from hostile takeovers, while other States relied on action taken by the board post-bid in order to block a hostile takeover. These States were therefore concerned that the BNR would nullify their ability to prevent hostile takeovers, leaving them vulnerable to cross-border bids, while the barriers in other countries would remain largely intact.

In all, Parliament wanted 20 amendments made to the proposal, the most significant of which was that the board of the target company be given extensive scope to be able to frustrate unwanted takeover bids. In January 2001, the Council responded to Parliament's amendments, clearly stating that Parliament's demands were unacceptable in their current form, thus beginning a period of 'conciliation' between the two parties. The process began in March 2001 and agreements were gradually made, point by point. Some points were met with relatively simple means, though in others both the Council and Parliament delegation made substantial concessions or dropped certain requirements.¹⁹

There was one area however where the two parties were unwilling to find common ground - on the issue of the BNR. The Council's 'Common Position' which had been reached over a year ago stated that defensive measures taken by the board to frustrate a bid, could only be

¹⁸ Ibid 8 at p14.

¹⁹ Ibid 9 at p309.

made with shareholder approval and only after the bid was announced. The Parliament delegation, led by German MEP Klaus-Heiner Lehne on the other hand, felt that the board should be able to take action prior to the announcement of a bid. The Council remained adamant that they were unwilling to compromise on this issue, an action which provoked the German business community into greatly intensifying their lobbying campaign, attempting to create a rift in the Council.²⁰

On 23 April, representatives from Volkswagen, BASF and other major German companies met with German Chancellor Gerhard Schröder, to issue their demands for changes to the proposed directive. Two days later, Germany informed the Council that they no longer backed the 'Common Position', and their support rested on the requirement for shareholder approval for frustrating actions to be removed, or that the BNR be removed entirely. The business community's lobbying campaign had been successful - now Germany stood isolated from the other Member States on the Council and were de facto siding with the Parliament.²¹

Abandoning the 'Common Position' after over a year of arduous negotiations was seen as a totally unacceptable move by many, and that Germany had overstepped the rules. Nevertheless, the Council stuck to its original position on the issue. The Parliament delegation used this new conflict within the Council to push harder during the negotiations which continued throughout May and into June of 2001. Still no final agreement had been reached, and as part of the 'Conciliation' process, the deadline for an agreement was June 6th. A final session took place on 5 June, with the help of Commission mediators. Eventually an agreement was reached. The Council had to concede a number of issues to the Parliament delegation, however the key argument over board neutrality was won by the Council, and it was agreed that the BNR would be a key provision of the Directive. The 'Conciliation' process was therefore complete and the only thing left to do was for Parliament in plenary to vote on the matter. Since the Parliament delegation had reached an agreement, most expected this to be a mere formality.

Vodafone and Mannesmann

At this point, it would be worthwhile to consider events that were occurring in the European markets. As before with Benedetti's attempted takeover of Société Générale de Belgique in 1988, now too would events on the securities market alter the perceptions of law-makers in

²⁰ Ibid 9 at p309.

²¹ Ibid 9 at p309.

the field of takeover law, though this time through an indirect route - corporate lobbyists. In 2000, Vodafone successfully completed a €175bn acquisition of the German conglomerate Mannesmann AG after a 3 month takeover battle.²² Not only did this constitute the largest ever takeover at the time, but it was unprecedented in that Vodafone was the first foreign company to succeed in a hostile takeover of a large German company.²³

The stock market in Germany plays a very limited role - relatively few large corporations are listed and those which are, have highly concentrated ownership structures, held by large blockholders. The "Rhenish Capitalism"²⁴ model of market economy found in Germany is characterised by extensive cross-shareholdings and a greater reliance on banks rather than stock markets. The cumulative effect being a lack of 'free-floating' shares for a bidder to acquire.²⁵ Thus, Germany has long been considered a fortress against hostile takeovers. It is not surprising then, that hostile bids were seen by many in Germany as a foreign, highly undesirable element in German business.

It was against this backdrop, of Germany's first successful hostile takeover, that several large German corporations became intensively involved in the European Parliament's response to the proposed Takeover Directive.²⁶ They wanted to eliminate the risk that they too, like Mannesmann, could fall into foreign hands, by ensuring that the board of directors had recourse to defensive actions that could be used to frustrate unwanted bids. Thus, when the Conciliation process between the Council and Parliament arrived at an agreed joint text which included the BNR, alarm bells were set ringing and a final attempt at lobbying the MEPs before the final vote, was begun. The Parliamentary vote was set for 4 July, a month after the Council and Parliamentary delegation had come to an agreement. In the days leading up to the vote, it became apparent that the German business community had not given up the fight and, Rolf Skog, Sweden's representative, described the corridors of Parliament as a scene of "feverish activity."²⁷

The day of the vote produced a quite unexpected and unique result. 273 voted in favour of the Directive and 273 voted against, with 22 abstaining. The Directive needed a simple majority to pass, but had failed to achieve this by a single vote. Legally the Directive had

²² Financial Times, 21st December 2005, available at <http://www.ft.com/cms/s/0/85db5080-7220-11da-9ff7-0000779e2340.html#axzz2m2s1WHfZ> <accessed 29/11/13>

²³ Janet Morrison, *The Global Business Environment: Meeting the Challenges* (3rd Edn, Palgrave Macmillan) Ch11.

²⁴ Michal Albert and Rauf Gonenc, 'The Future of Rhenish Capitalism' (1996) *The Political Quarterly*, 67, 184-193.

²⁵ *Ibid* 23, Ch11.

²⁶ *Ibid* 9 at p308. Recall also the meeting between representatives of VW, BASF and others with Chancellor Schröder, above.

²⁷ *Ibid* 9 at p310.

been rejected, ending the process. Nevertheless, the EU Commission was free to begin again, which is exactly what they did.

A New Attempt and the High Level Group of Company law experts

Though the Commission's disappointment at the result of the vote was evident,²⁸ both the Council and Commission had stressed in different settings that they envisioned the Takeover Directive as a vital puzzle piece in the realisation of an internal market.²⁹ Thus it is no surprise that, following the stalemate in the European Parliament in July 2001, the Commissioner for the internal market, Frits Bolkestein, immediately announced plans for a new draft of the Directive.

The Commission's first action was to engage a 7-man group of company law experts (the High Level Group of Company Law Experts) chaired by Professor Jaap Winter.³⁰ The Group's role was to provide independent advice on the rules relating to pan-European takeovers and resolve the issues that had been raised by the European Parliament. The group published its first report in January 2002 and the recommendations it contained revolved around two guiding principles: shareholder decision making; and proportionality between risk bearing capital and control.³¹

Of primary interest to this thesis are the BNR and BTR. Both can be derived from the abovementioned principles respectively and were recommended to be included in the Directive by the High Level Group, as detailed by 'Recommendations 1.2 and 1.4' of the Report.³²

The first principle, inter alia, manifests itself as the BNR. Shareholders should be the ultimate decision makers when a takeover bid is received, not the board of the target company. Some opposition has been levelled at this principle³³ but the High Level Group rejected this based on the 'insolvable conflict of interest'³⁴ with which managers are faced in

²⁸ European Commission, 'Commission regrets rejection of Takeovers Directive by the European Parliament' (Press release IP/01/943). In this press release, Internal Market Commissioner Frits Bolkestein commented, "Twelve years of work have been wasted by today's decision [the Parliamentary vote]... It is tragic to see how Europe's broader interests can be frustrated by certain narrow interests.'

²⁹ Ibid 9 at p310.

³⁰ European Commission, 'Commission creates High Level Group of Company Law Experts' (Press release IP/01/1237, Brussels, 4 September 2001).

³¹ Ibid 8 at p20 et seq.

³² Ibid 8 at p6.

³³ See Chapter 3 of this thesis which discusses the Board Neutrality Rule.

³⁴ Ibid 1 at p11.

a takeover situation - it would be naïve to expect managers to sacrifice their jobs and reputations in order to maximise the value of the company for shareholders.

The BTR that the High Level Group advocated can be derived from the second guiding principle, of proportionality between risk bearing capital and control. The High Level Group's argument was as follows:

The holders of such capital are entitled to participate in the profits of the company and the residual assets in event of liquidation. They are best placed to decide on the affairs of the company as they are the ultimate economic risk bearers of their own decisions and should therefore be granted control rights in proportion to the risk they bear. Thus, control structures with disproportionate voting rights should not frustrate a bid where a majority of the risk-bearing, but not voting-capital is acquired³⁵.

Therefore, they recommended a 'Breakthrough Rule' which was designed to allow an acquirer of a set percentage (75%) of the risk-bearing capital to 'break-through' mechanisms and structures designed to frustrate a bid, as defined in the articles of association and other related documents.

1.2 The Final Draft Proposal and Adoption

The recommendations put forth by the High Level Group were interpreted broadly by the Commission when they published the third draft Directive in October 2002.³⁶ As expected, the basis of the new draft was the joint text that had been approved by the Council and the European Parliament delegation in June 2001, as part of the 'Conciliation process.' Accordingly, much of the draft remained untouched, though the High Level Group's recommendations influenced the inclusion of a 'squeeze-out' (Article 14) and 'Sell-out' (Article 15) rule, as well as a common definition of 'equitable price' (article 5).

The real controversy remained however with the anti-takeover defences. The Commission, in accordance with the recommendation of the High Level Group, kept the BNR (Article 9) which had been the source of such troublesome negotiations before.

³⁵ Ibid 8 at p3.

³⁶ Commission of the European Communities, Proposal for a directive of the European Parliament and the Council on takeover bids (13th directive), Brussels, 2 October 2002, COM(2002) 534 final.

On the other hand, the Commission acknowledged that the BTR, as proposed by the High Level Group was "opposed by virtually all Member States and interested parties."³⁷ Nevertheless, they followed the logic behind the BTR and included Article 11, which stipulated that restrictions on transfers of securities and restrictions on voting rights would be unenforceable against the offeror, or cease to have effect once a bid had been made public.³⁸ Thus, elements of the BTR were adopted, though as a matter of politics, only in part.³⁹

The Portuguese Compromise and the Formal Adoption of the Directive

It took nearly two more years of intense bargaining, but eventually the Directive was formally adopted in April 2004. The controversy and disagreements surrounding the BNR and now additionally the BTR did not abate however. Indeed it took a major compromise before a final agreed text could be reached, and be approved by the European Parliament. The 2012 Study by Marccus Partners, undertaken on behalf of the Commission, summarises this compromise as follows:

"one of the most controversial proposed aspects of the Directive was whether to adopt the board neutrality rule (Article 9 of the Directive) and the breakthrough rule (Article 11 of the Directive). These provisions were controversial because they crystallise oppositions on the value of facilitating and frustrating takeovers. In order for the Directive to be enacted, the Member States eventually agreed to a compromise suggested by Portugal, in late 2003. The compromise made was essentially to make Articles 9 and 11 of the Directive optional. That is, Member States could opt out of transposing the board neutrality or breakthrough rule, or both, but they could not prevent individual companies from voluntarily opting in to the rules. This compromise made Articles 9 and 11 of the Directive options for which there are two levels of possible adoption: at the national level, and then at the company level. Even if the breakthrough or board neutrality rule is adopted at the national or company level, the Portuguese compromise further introduced a third option: reciprocity. If a Member State allowed for reciprocity, even if one or both of the

³⁷ Ibid at p4.

³⁸ Ibid at p4.

³⁹ Ibid 1 at p16.

*opt-in rules is adopted, a company still has the option not to apply the rule when faced with an offeror who has not adopted the same rule*⁴⁰

Despite the success of finally being adopted, it was not the Directive that the Commission had originally envisioned. The optional nature of Article 12 meant that it constituted a 'flexible framework'⁴¹ Directive rather than a regulatory instrument with specific rules. The primary reason for the Directive in the eyes of the Commission was to promote the integration of the national economies in the European 'Single Market' and to facilitate takeover bids, thereby enhancing the competitiveness of the European market,⁴² in accordance with their 2002 proposal.⁴³ One way they aimed to achieve this was the much touted 'creation of a level playing field' between the Member States, yet by making two of the key provisions of the Directive optional, the door was left wide open for the Member States to transpose the Directive in a protectionist manner that served individual national interests rather than harmonising takeover defences. Therefore, as pointed out by Davies et al, the transposition decisions of the Member States regarding this Directive were far more significant than usual.⁴⁴

The next section will look at how the Member States implemented the Directive in the national legal systems. The key focus of this will be on which States chose to implement the Board Neutrality and Breakthrough rules and which chose to opt-out under Article 12 of the Directive. As will be shown, by allowing the Member States to opt-out of key provisions at the national level, the Directive failed in its objective of harmonising takeover law, allowing the varied corporate cultures to remain largely intact throughout Europe.⁴⁵

The compromise making the provisions optional was, unsurprisingly, bitterly opposed by Commissioner Bolkestein, who remarked that it made the Directive "not worth the paper it's written on."⁴⁶

⁴⁰ Marccus Partners, The Takeover Bids Directive Assessment Report,

⁴¹ Wouters et Al. (2009) 'The European Takeover Directive: a commentary', in Hooghten P.V. (Ed.): *The European Takeover Directive and Its Implementation*, pp.3–76, Oxford University Press, New York.

⁴² Davies, Paul L. and Schuster, Edmund-Philipp and van de Walle de Ghelcke, Emilie, *The Takeover Directive as a Protectionist Tool?* (February 17, 2010). ECGI - Law Working Paper No. 141/2010 at pp2-3.

⁴³ Commission of the European Communities, *Proposal for a Directive of the European Parliament and of the Council on Takeover Bids*, COM (2002) 534 final, Brussels, October 2002 p3.

⁴⁴ Ibid 42 at p3.

⁴⁵ Ibid 4 at p11.

⁴⁶ Financial Times, 18th October 2004, p6.

1.3 The Status of Transposition

Transposition is now complete in all sample States. It should be stated that Croatia recently acceded to the European Union as the 28th Member State in July 2013 and will not be considered in this thesis. Many sample countries implemented the Directive gradually through several pieces of legislation rather than in one go. As such, 12 sample countries had failed to implement the Directive by the transposition deadline. The following table shows the year in which the respective Member State fully or substantially transposed the Directive:

Year	Countries
2005	Poland, Romania.
2006	Austria, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Luxembourg, Portugal, Sweden, UK.
2007	Belgium, Cyprus, Italy, Netherlands, Slovakia, Spain.
2008	Czech Republic, Estonia.

Transposition of the Board Neutrality and Breakthrough Rules

The compromise discussed above which was necessary to adopt the Directive rendered the BNR and BTR optional, giving Member States the discretion whether or not to apply them. However, Article 12 further stipulated that if a Member State decides not to make these rules mandatory, it cannot prevent an individual company from applying either or both of the rules on a voluntary basis. Furthermore, the 'Reciprocity' exception (Article 12(3)) allows Member States to authorise companies applying the BNR and BTR to cease applying them when faced with a bid from an offeror that is not himself subject to these rules in his country.

Such a complex system of options can hardly be seen as a successful method of harmonising takeover regulation throughout Europe. Since the theme of this chapter has been to look at how politically and economically sensitive the landscape of takeover regulation is, the following table highlights the nature of this issue. It shows which countries implemented the BNR and BTR, but the key information to take away is whether implementation of the Directive brought about a change in the takeover regime of the particular Member State with regards to the BNR and BTR, or whether the State remained with its status quo. Many Member States had a BNR in place, prior to implementing the Directive. Therefore, despite adopting the Rule, their regime retained the status quo.

Country	Board Neutrality Rule	Breakthrough Rule
Austria	Yes - not new	No - not new
Belgium	No - not new	No - not new
Bulgaria	No - not new	No - not new
Cyprus	Yes - new	No - not new
Czech Republic	Yes - not new	No - not new
Denmark	No - not new	No - not new
Estonia	Yes - not new	Yes - new
Finland	Yes - new	No - not new
France	Yes - not new	No - not new
Germany	No - not new	No - not new
Greece	Yes - not new	No - not new
Hungary	No - not new	No - not new
Ireland	Yes - not new	No - not new
Italy	Yes - not new	No - not new
Latvia	Yes - new	Yes - new
Lithuania	Yes - not new	Yes - new
Luxembourg	No - not new	No - not new
Malta	Yes - new	No - not new
Netherlands	No - not new	No - not new
Poland	No - not new	No - not new
Portugal	Yes - not new	No - not new
Romania	Yes - new	No - not new
Slovakia	Yes - not new	No - not new
Slovenia	Yes - not new	No - not new
Spain	Yes - not new	No - not new
Sweden	Yes - not new	No - not new
UK	Yes - not new	No - not new

Source: *Takeover Bids assessment report*⁴⁷ and *Davies et al*, see nr 42 above.

This table shows that 19 out of 27 Member States (Austria, Cyprus, the Czech Republic, Estonia, Finland, France, Greece, Ireland, Italy, Latvia, Lithuania, Malta, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the UK) impose the BNR. While 19 out of 27 States may seem like a success for the Directive, it is important to consider that only 5 Member States introduced the BNR as a result of the Directive. In addition, the States in which the

⁴⁷ Marccus Partners, *The Takeover Bids Directive Assessment Report*, available at http://ec.europa.eu/internal_market/company/takeoverbids/index_en.htm.

Directive brought about change tend to have very small capital markets relative to the rest of Europe. Cyprus, Finland, Latvia, Malta and Romania account for only 2% of the total of EU capital markets.⁴⁸ In economic terms therefore the BNR under the Directive has had a minimal impact.

Moreover, the only countries to fully transpose the BTR are Estonia, Latvia and Lithuania. Again, these Member States represent on a tiny fraction of the EU capital markets total. The reasons for this will be discussed in Chapter 4 of this thesis. The key point to take away from this, is the clear opposition the majority of Member States have towards the rule. Such widespread rejection of the rule highlights the clear problems the Member States have with it and once again show the optionality compromise of the Directive was necessary in order for its adoption. The Member States of the European Union were not ready for a full regulatory takeover regime - a framework was the limit they were willing to agree to. Thus, a flexible options-based regime was the result of political compromise. The question this thesis seeks to answer is whether this represents the optimal takeover regime for Europe. If this answer is negative, then the question becomes how the BNR and BTR could be reformed in order to further the positive advancement of EU takeover law. To do this, the next chapter shall look at the underlying economic evidence and theory behind takeovers.

⁴⁸ Ibid 42. See also chapter 3 of this thesis.

Chapter 2 – The Economic Theory of Takeover Regulation

Chapter Introduction

Any given takeover can either be wealth-creating or wealth-destructive. An efficient (i.e. wealth-creating) outcome hinges on a variety of factors and in spite of careful forecasts and projections based on probabilistic information, it is only revealed *ex post* whether the takeover was efficient or not.¹

The economic analysis in this chapter will conclude that both hostile and friendly takeovers average out to be efficient and thus create wealth.² However there is no way of knowing *ex ante* whether any individual takeover will be efficient or not. The real-world result of this is that in certain instances wealth-destructive takeovers can be approved while other wealth-creating takeovers do not go ahead.

A regulatory framework which facilitates takeovers (a pro-takeover regime) would see wealth-creating takeovers become more common, but so too would wealth-destructive takeovers. On the other hand a takeover restrictive regime would prevent more inefficient takeovers, but also block wealth-creating ones. The debate surrounding hostile takeover regulation therefore boils down to whether hostile takeover attempts should be facilitated or impeded.³ Of course, such a question does not adequately reflect the richness of the debate or the nuanced viewpoints of the many commentators, however the level of contestability of corporate control is undoubtedly the central issue of takeover regulation.

The chapter will look at the economic evidence on the wealth-effects of hostile takeovers (and for comparison, friendly takeovers). The BNR and BTR are both means to facilitate takeovers and thus form a basis for a pro-takeover regime. Allowing Board defences on the other hand is a staple of a takeover restrictive regime. This chapter will therefore consider the economic evidence behind each regime, before briefly considering how the evidence would support an 'unbiased' approach.

¹ Luca Enriques, Ronald Gilson, Alessio Paces The Case for an Unbiased Takeover Law (with an Application to the European Union) (May 1, 2013) at p2. ECGI - Law Working Paper No. 212; Columbia Law and Economics Working Paper No. 450; Stanford Law and Economics Olin Working Paper No. 444. Available at SSRN: <http://ssrn.com/abstract=2258926>.

² See section 'Conclusions on the benefits of hostile takeovers', below.

³ *Ibid* 1 at p2.

2.1 The meaning of wealth in the takeover context

Firstly it would be useful to set a definition of wealth-creating and wealth-destructive takeovers. Which category a given takeover will fall into can be qualified by calculating whether the winners' gains exceed the losers' losses, net of transaction costs.⁴ This is the 'Kaldor-Hicks efficiency' and states that an outcome is efficient if those who benefit could *in theory* compensate those who are worse off, and still be in a better position.⁵

For the purpose of this thesis only the wealth effects of shareholders will be considered - the wealth effects on stakeholders (employees, local communities, customers) will be ignored. This is not to say that the wealth effects on these groups are unimportant, but rather such effects are extremely difficult to quantify in comparison to the effects on shareholders, which can easily and accurately be quantified by the currency values applied to share prices. This yields an efficient evaluation criterion and is the norm in financial theory.⁶

Further, as Enriques et al point out, takeovers are only one way a corporation responds to changing economic conditions. Competition can force corporations to make workers redundant, lower wages, and close plants. Thus takeovers are just one of a range of mechanisms through which competition operates and equilibration occurs.⁷ Since takeover regulation is neither the only nor the best means of safeguarding the interests of these stakeholders, the wealth effects on these groups are not considered in the discussion on takeover regulation.⁸

Therefore when the terms 'wealth-creating' and 'wealth-destructive' are used, this refers specifically to shareholder wealth.

2.2 Hostile takeovers: pro, restrictive and neutral regimes

There are 3 distinct schools of thought of how to approach takeover regulation which can be categorised as the following; those who advocate a pro-takeover regime, those who favour restrictive regime, and those who take a neutral (or unbiased) stance. This following section will evaluate the literature and empirical evidence for each position, before concluding.

⁴ Ibid 1 at p7.

⁵ John R Hicks, *The Foundations of Welfare Economics*, 49 *ECON J* 696 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, *ECON J* 549 (1939).

⁶ M Martynova & L Renneboog, 'A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?' (2008) 32 *Journal of Banking and Finance* 2148 at p2156.

⁷ Ibid 1 at p7.

⁸ The High Level Group of Company Experts were of the opinion that such stakeholders should be protected by specific rules e.g on labour law and environmental law. High Level Group of Company Law Experts, *Report on Issues Related to Takeover Bids*, Brussels 10 January 2002 at p22.

2.3 Analysis of a pro-takeover regime

According to pro-takeover commentators, takeovers are overall beneficial for corporate governance. They argue that a mechanism which facilitates takeover bids, effects two main economic benefits. The High Level Group of Company Law Experts identified these as:⁹

- a) a mechanism for disciplining poorly performing management,
- b) exploitation of synergies between bidder and target to create wealth.

This section will consider the economic benefits of takeovers and thus whether the support for a pro-takeover regime is justified.

Disciplining Management

Hostile takeovers were first recognised as a means of disciplining management in the 1950s. According to Rostow, “the raider persuades the stockholders for once to act as if they really were stockholders, in the black-letter sense of the term, each with the voice of partial ownership and a partial owner’s responsibility for the election of directors.”¹⁰ Put differently, in companies with dispersed ownership structures, underperforming management may not face activism from shareholders due to rational apathy and collective action problems.¹¹ Managerial underperformance equates to an inefficient use of the company’s resources, and though theoretically empowered, the shareholders are unable to replace the management. In this scenario, a hostile bid forces the dispersed shareholders into action and allows for the reallocation of resources to a more efficient user (the bidder).¹²

Where management is underperforming, market theory dictates that this will be reflected in a drop in the share price, attracting third party management who will offer a premium on the shares via a hostile tender. This suggests that the management team of the acquiring firm, having an excess of managerial competence, can efficiently manage the larger amount of resources that the firm being acquired possesses, in which the target management was unable, for the opposite reasons of inefficiency, to manage the assets it controlled.¹³ The new management will hope to utilise the resources more efficiently and therefore be met with a corresponding rise in share price, allowing them to recoup the initial premium.

⁹ Ibid at p19.

¹⁰ E. Rostow, . “To whom and for what ends are corporate managements responsible?” In: Mason, E.S. (Ed.), *The Corporation in Modern Society*. Harvard University Press, Cambridge, MA. (1959) p47.

¹¹ P. Davies, Edmund-Philipp Schuster, & Emilie van de Walle de Ghelcke, *The Takeover Directive as a Protectionist Tool?* in *Company law and economic protectionism: New challenges to European Integration* (Ulf Bernitz & Wolf-Georg Ringe eds. 2010). p13.

¹² R Gilson, “A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers” (1981) 33 *Stanford Law Review* 819, 841.

¹³ G. Tsagas, *EU Takeover Regulation: One Size Can't Fit All* (November 1, 2010). *International Journal of Private Law*, Vol. 4, No. 1, pp.171–184, January 2011. Available at SSRN: <http://ssrn.com/abstract=1922295> p178.

In theory this is a desirable control shift, as it reallocates resources to a more efficient user, generates wealth for the target shareholders (who receive the premium) and creates a more efficient company.

The disciplinary effect is not limited to actual (observable) control transfers. A pro-takeover regime would exert pressure on incumbent management to operate their companies efficiently, or otherwise be replaced.¹⁴ Here, the disciplining effect aligns shareholders' and managers' interests, reducing agency costs by dealing with the principal-agent problems between shareholders and management.¹⁵ From a policy perspective, this is a logical effect to employ, the end result being resources shifted into the hands of those best able to manage them, thus producing more efficient control structures.¹⁶

Questions have been raised however about the validity of the disciplining effect of takeovers. Firstly, commentators make the point that the disciplining effect is only relevant to companies with a dispersed shareholder ownership which face collective action problems. This is not the case in companies where there is a controlling blockholder,¹⁷ who does have sufficient incentive to monitor the management and replace them if necessary.¹⁸ As figures 1 and 2 below show, the majority of companies in continental Europe are controlled by blockholders. Some commentators therefore argue the disciplining effect serves little purpose there, and is only relevant in the UK.

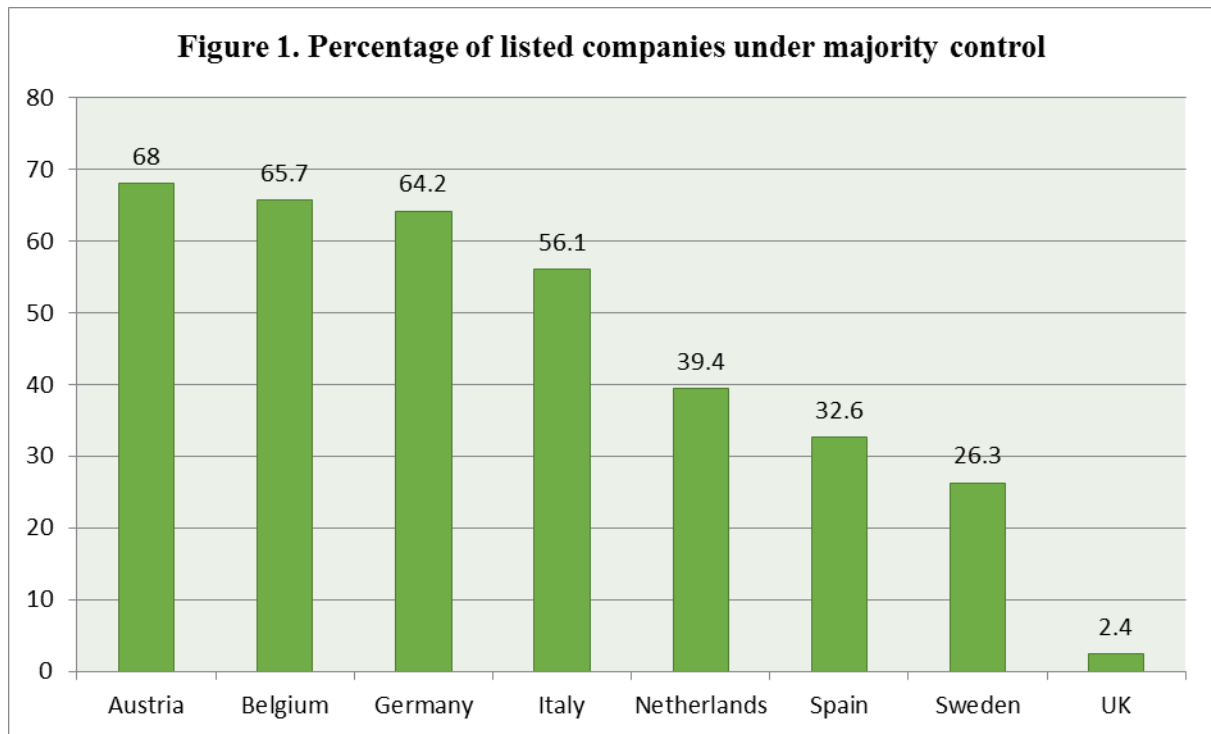
¹⁴ A. White, Reassessing the Rationales for the Takeover Bids Directive's Board Neutrality Rule (October 1, 2012). *European Business Law Review*, Vol. 5, No. 23, 2012. Available at SSRN: <http://ssrn.com/abstract=2205109>. p792.

¹⁵ See R. Romano, 'A guide to takeovers: theory, evidence and regulation', *Yale Journal on Regulation*, (1992) Vol. 9, pp.119–179; and A. Dignam, 'The globalisation of general principle 7: transforming the market for corporate control in Australia and Europe', *Legal Studies*, (2008) Vol. 28, No. 1, pp.96–118.

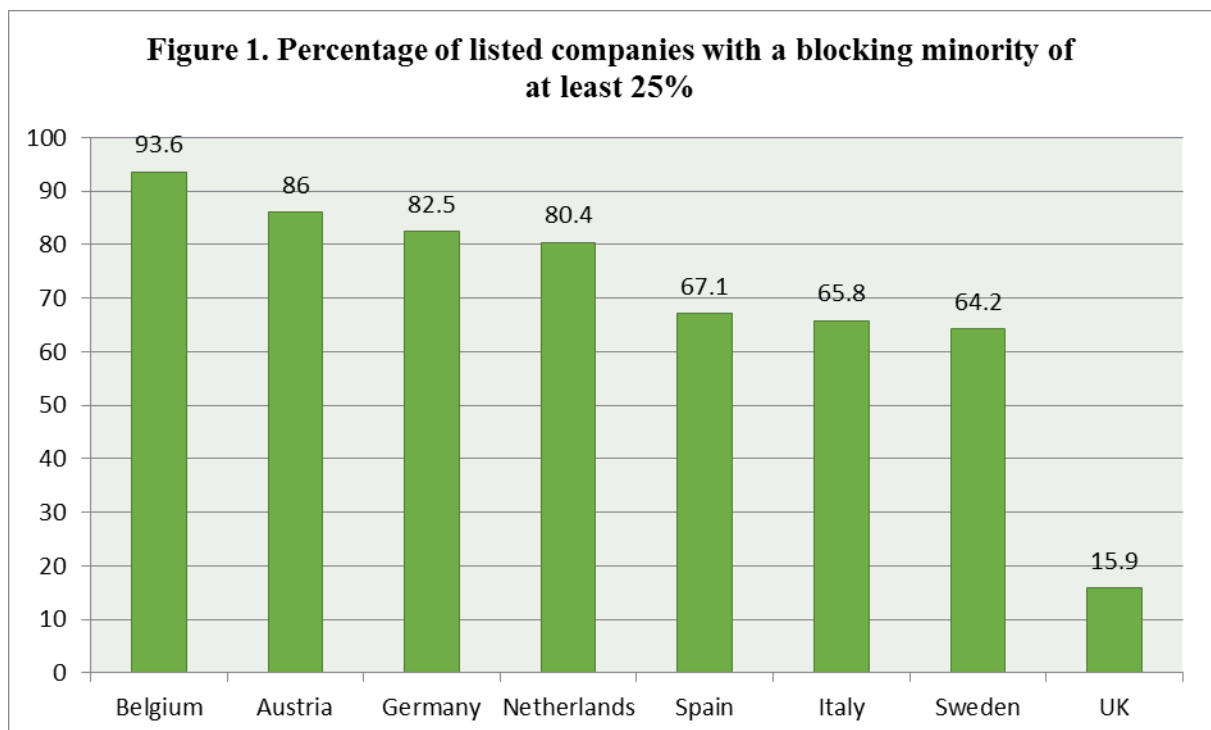
¹⁶ *Ibid* 11.

¹⁷ The term 'blockholder' is used to refer to a shareholder of the company, who under normal circumstances, can exercise effective control over the company due to his shareholding.

¹⁸ *Ibid* 11 at p14.



(Source - McCahery and Renneboog 2003)



(Source - McCahery and Renneboog 2003)

One of the proponents of this line of reasoning states that, "the overall picture suggests, therefore, a market for corporate control that has lacked, and may likely continue to lack, much disciplinary effect in much of continental Europe."¹⁹ However, this conclusion is disputed - while it is recognised that the blockholding share ownerships that are the norm in continental Europe often do nullify the disciplinary effect of a takeover, to say the disciplinary effect has no relevance there at all is incorrect.

Firstly, the issue is which type of ownership structure a company has, dispersed or blockholder, rather than which category is the majority in a given jurisdiction. Though unusual, companies with dispersed ownership can be found in jurisdictions where blockholder control is typical and the disciplinary effect of takeovers will therefore have some relevance.²⁰

Secondly, empirical evidence points to a discernible trend towards an increase in companies not under blockholder control in continental Europe, and a move towards more dispersed ownership. Franks et al²¹ used a (relatively generous) test of no shareholder having more than 25% as a criterion of a company having dispersed ownership. Their study considered Germany, France, Italy and the UK, between 1996-2006. The UK remained steady at >90% while in all three continental jurisdictions, the percentage of dispersed companies increased:²²

	Percentage of companies with dispersed ownership (1996)	Percentage of companies with dispersed ownership (2006)
France	21%	37%
Germany	26%	48%
Italy	3%	22%

These figures suggest that the pressures of globalisation and the expansion of the single market within the European Community are generating greater dispersed ownership within continental markets²³. A continuation of this trend will therefore correlate positively with a greater relevancy of the disciplining effect of takeovers in continental Europe as dispersed ownership continues to become more prevalent.

It seems therefore that the argument that the disciplinary effect of takeovers has no relevance in continental European markets is debateable. But even if this is the case,

¹⁹ Ibid 14 at p793.

²⁰ Ibid 11 at p14.

²¹ J Franks, C Mayer, P Volpin and H Wagner, 'Evolution of Family Capitalism: A Comparative Study of France, Germany, Italy and the UK' EFA 2009 Bergen Meetings Paper, available at <http://ssrn.com/abstract=1102475>.

²² Ibid, Table 2, Panel B.

²³ Ibid 11, at p17.

empirical evidence shows that the relevance of the disciplinary effect may be questioned from another angle. As was discussed above, and is a common argument in the literature,²⁴ companies with underperforming management should become targets for a hostile bid, in which the company resources can be managed more efficiently by a different management, thus allowing a desirable control shift.

However, the empirical evidence shows that this is not the case. The prediction that hostile takeovers should primarily target underperforming companies is not borne out by the evidence.²⁵ In a study of US companies undertaken in 2000, Schwert identified variables that could indicate poor performance of a company such as low market-to-book ratios and return on assets and concluded that these contributed little to nothing to whether a firm would be the target of a hostile bid.²⁶ The available evidence for the UK also fails to show that targets of hostile bids had poorer pre-bid performance than other targets. Franks and Meyer (1996)²⁷ looked at pre-bid share price, cash flow, dividend payout and Tobin's Q²⁸ as indicators of poor performance, but similarly concluded that the evidence failed to show that the targets of hostile bids had poorer pre-bid performance than other targets.

Conclusions on the Disciplining Effect of Hostile Takeovers

A widely accepted²⁹ motive for hostile takeovers is the displacement of inefficient management, thus making them a beneficial external corporate governance mechanism by disciplining inefficient management. As Brealey and Myers contend, "there are always firms with unexploited opportunities to cut costs and increase sales and earnings. Such firms are natural candidates for acquisition by other firms with better management"³⁰ Yet despite its general acceptance by financial economists and legal commentators, there is very little empirical evidence to support this hypothesis³¹ - studies show that hostile bids are not aimed at underperforming companies. Nevertheless, this data only applies to *actual* bids, the disciplining effect may still play an *ex ante* role on incumbent managers, as the threat of

²⁴ Marccus Partners, The Takeover Bids Directive Assessment Report, p274.

²⁵ Marco Becht, Patrick Bolton, & Ailsa Röell, *Corporate Law and Governance*, in Handbook of law and Economics, p879 (A. Mitchell Polinsky and Steven Shavell eds., 2007).

²⁶ G. Schwert, . "Hostility in takeovers: in the eyes of the beholder?" *Journal of Finance* (2000) 55, 2599–2640

²⁷ J. Franks, Mayer, C. "Hostile takeovers and the correction of managerial failure". *Journal of Financial Economics* (1996) 40, 163–181

²⁸ The 'Q ratio' is calculated by dividing the company's market capitalisation by the total replacement value of its assets. A value between 0-1 indicates the company is undervalued, while a value >1 indicates it is overvalued.

²⁹ See e.g the High Level Group of Company law Experts report, above n8, which identified the disciplining effect of takeovers as one of the reasons why they are "basically beneficial".

³⁰ R. Brealey, . Myers, C. *Principles of Corporate Finance*, 2000, p945 (Mcgraw Hill, New York)

³¹ Kini, O., Kracaw, W. and Mian, S, The Nature of Discipline by Corporate Takeovers. *The Journal of Finance*, (2004) 59, at p1549.

replacement if perceived to be underperforming provides an incentive to operate the company efficiently.³²

Overall however it would seem that the beneficial disciplining effect of hostile takeovers is overstated, leading to much of the academic literature attaching too much weight to the benefits of the effect. This is an important consideration to be taken into account when crafting takeover regulation.

Exploiting synergies to create wealth

In addition to the disciplining effect, the other classically stated benefit of hostile takeovers (equally applicable to friendly) is the creation of wealth by exploiting synergies. Here, contestability of corporate control serves a more general efficiency purpose.³³ The target's assets in this scenario are of unique value to the acquirer.³⁴ Combining the assets of these firms creates value through synergies, which cannot be achieved by even the most talented and diligent managers of the target.³⁵

These synergies can be classed as either operating or informational. Operating synergies arise from combining assets which allow for economies of scale³⁶ or scope.³⁷ Informational synergies are generated when the value of the combined assets of the companies is greater than the value the stock markets attribute to them individually.³⁸ For example, this often constitutes a slack-rich company with poor growth opportunities acquiring a slack-poor company with excellent growth opportunities, resulting in the combined firm having the necessary capital to realise the potential for growth. The exploitation of synergies in this way to create wealth is the main driver behind mergers and acquisitions in addition to being a motive for hostile bids.

³² Ibid 13 p178.

³³ Ibid 11 at p13.

³⁴ R Romano, 'A Guide to Takeovers: Theory, Evidence, and Regulation' (1992) 9 Yale Journal of Regulation 119, 125-129.

³⁵ Ibid 11 at p 13.

³⁶ An economy of scale are factors which reduce the average cost of production as the volume of production increases. I.e production on a larger scale is cheaper.

³⁷ An economy of scope consists of factors that make it cheaper to produce a range of products together than to produce each one of them on its own. Such economies can come from businesses sharing centralised functions, such as accounting or marketing.

³⁸ J. McCahery, L. Renneboog, and Ritter, Peer and Haller, Sascha. (2003) *The Economics of the Proposed European Takeover Directive*. CEPS Reports in Finance and Banking No. 32, 1 April 2003 at p18.

Unsurprisingly, the wealth creation benefit of hostile takeovers has received extensive amounts of academic attention and numerous empirical studies have been undertaken.³⁹ As with this thesis, these have focused largely on shareholder wealth⁴⁰ (as opposed to other stakeholders). Traditionally, the focus has been on changes in short-term shareholder wealth, but long-term wealth and combined firm operating performance have received significant attention.

Wealth creating synergies of hostile takeovers were identified as one of the attributes of hostile takeovers which make them "basically beneficial"⁴¹ according to the High Level Group of Company Law Experts and one of the reasons for facilitating takeovers. But it is questionable whether this reasoning is supported by the empirical evidence. This section will consider both the short and long-term wealth-effects of hostile takeovers.

Short term wealth effects of hostile takeovers

Analysing short term shareholder wealth effects hinges on the premise that a hostile bid announcement brings new information to the market, such that investors expectations about the firm's prospects are altered, resulting in a corresponding change in share price.⁴²

When it comes to target shareholders the studies unanimously find that they receive substantial positive returns. Both friendly and hostile bids result in positive returns for target shareholders, but this is significantly higher with a hostile bid. In a study of US companies it was found that the 'cumulative average abnormal returns'⁴³ (CAARs) for a friendly bid were 22% and 32% for hostile bid.⁴⁴ Similarly, in a study of UK companies it was found that friendly bids triggered CAARs of 18% and nearly 30% for hostile bids.⁴⁵

On the other hand, when it comes to the shareholders of acquiring firms, the difference is striking. Martynova and Renneboog surveyed 65 studies and found that the average CAARs for bidder shareholders for all types of takeover (both hostile and friendly) was indistinguishable from zero.⁴⁶ However while the returns for friendly takeovers tended to be

³⁹ See Martynova and Renneboog, *n6 above* and Becht, *n25 above*, for an excellent overview of the studies.

⁴⁰ Because, inter alia, shareholders are the residual owners of the company and thus bear the ultimate risk.

⁴¹ Ibid 8 at p22.

⁴² Ibid 6 at p8.

⁴³ H. Servaes, 1991, Tobin's Q and the Gains from Takeovers, *Journal of Finance* 46 (1), 409-419.

⁴⁴ Ibid. The event window for this study was day 0 (announcement day) - close (day target delisted).

⁴⁵ J. Franks, and C. Mayer, 1996, Hostile takeovers and the correction of managerial failure, *Journal of Financial Economics* 40, 163-181. The event window for this study was day 0 - day 20.

⁴⁶ Ibid 6 at p11.

insignificantly positive, shareholder returns for firms making hostile bids tended to be negative.⁴⁷

McCahery and Renneboog in a 2003 study looked at European takeovers between 1993-2000 with a deal value of greater than \$100 million. Tables 3 and 4 below show the CAARs over various event windows of target and bidding firms.

Table 3 - Cumulative average abnormal returns of target shareholders

Time Interval	Merger	Friendly Acquisition	Hostile Acquisition	Multiple Bidders
Event Window (days)	%	%	%	%
[-1, 0]	8.80	5.96	12.60	6.89
[-2, +2]	12.62	11.33	17.95	11.28
[-40, 0]	23.41	20.34	29.23	23.68
[-60, +60]	23.59	26.52	28.36	20.53
Observations	40	53	28	14

(Source - McCahery and Renneboog 2003)

Table 4 - Cumulative average abnormal returns of bidder shareholders

Time Interval	Merger	Friendly Acquisition	Hostile Acquisition	Multiple Bidders
Event Window (days)	%	%	%	%
[-1, 0]	2.20	2.43	-2.51	-0.08
[-2, +2]	4.35	1.94	-3.43	0.85
[-40, 0]	4.63	4.68	-2.51	-1.04
[-60, +60]	3.03	-1.67	-0.69	-2.96
Observations	41	55	32	17

(Source - McCahery and Renneboog 2003)

These tables show similar findings to the survey undertaken by Martynova - shareholders of target firms receive substantial premiums over the market price, and this effect is amplified where the bid is hostile. On the other hand, shareholders of bidding firms in hostile bids saw negative abnormal returns, whereas in friendly takeovers (mergers and acquisitions in the above tables) the bidder's shareholders saw positive returns.

The next logical step is to consider what the combined wealth effects are for both bidder and target shareholders. It was discussed above that according to the Kaldor-Hicks efficiency, a

⁴⁷ Ibid.

takeover is efficient if the winners' gains exceed the losers' losses. Since the premium received by target shareholders is so substantial, and despite the target firms often being considerably smaller (and thus a lower total market value than the bidder), the net overall wealth-effects for the combined shareholders is positive.⁴⁸ In a 2005 study⁴⁹, Bhagat et al calculated the 'Combined Initial Bid Return'⁵⁰ (CIBR), using a [-5,+5] day window either side of the bid announcement. Their results showed that, target and bidder shareholders combined received abnormal returns of 8.43% in the case of hostile bids, and 4.38% for friendly offers.⁵¹

In other words, at least in the short term, hostile takeovers are on average wealth-creating. At face value, following this logic would assume that a pro-takeover regime that facilitates hostile bids is therefore desirable, since they create wealth in the aggregate. Many legal and economic scholars have been content to rely on the evidence of short-term wealth-creation as proof of the efficacy of the market for corporate control,⁵² however it is submitted that a more holistic approach should be taken in order to accurately measure the benefits of takeovers, by considering other measures such as long-term wealth-effects and firm operating efficiency.

Long-term wealth effects of hostile takeovers

Many studies have been undertaken on the long-term wealth-effects of takeovers, considering the abnormal returns that the shareholders of the combined firm receive, usually over periods of 1-5 years. Unlike with short-term effects however, the empirical evidence here is less conclusive. Franks, Harris and Titman (1991) found that hostile takeovers in the US outperformed friendly ones. Hostile takeovers had cumulative abnormal returns (CAR) ranging from 0.1% to 1.3% in the three-year post-acquisition period, while the CAR of friendly mergers ranged from -0.3% to 0.8%.⁵³ Similarly Loughran and Vjih (1997) found that,

⁴⁸ Ibid 14 at p796.

⁴⁹ S. Bhagat, M. Dong, D. Hirshleifer and R. Noah, 2005, "Do Tender Offers Create Value? New Methods and Evidence," *Journal of Financial Economics*, 76, 3–60

⁵⁰ The combined initial bid return is a weighted average of bidder and target abnormal returns.

⁵¹ Ibid 49 at p34-35. See also Bradley, Desai and Kim (1988) who report that investors who own an equal share in both the bidder and the target one week prior to the event date and sell their entire holdings one week after the event day will have earned an abnormal return of 7-8%. (Study conducted over the period 1963-84).

⁵² Ibid 14 at p796.

⁵³ J. Franks, Harris, R. and Titman, S. (1991), 'The postmerger share-price performance of acquiring firms', *Journal of Financial Economics*, Vol. 29, pp. 81-96.

on average over a five year period, stock returns of the acquirer are significantly higher in hostile offers as opposed to mergers.⁵⁴

With regards to the UK, a comparatively recent study by Cosh and Guest⁵⁵ found that over a four year period, "hostile takeovers result in mildly negative abnormal returns, whilst friendly takeovers result in significantly negative returns."⁵⁶

The empirical evidence on hostile takeovers is therefore somewhat inconclusive. Some studies show that bidder shareholders receive small but positive gains, while others show small but negative returns. However the evidence does seem to show two consistent results. Firstly, the wealth change in hostile acquisitions, whether positive or negative tends to be small ("not significantly different from zero")⁵⁷, and secondly that hostile acquisitions outperform friendly ones over a long time period.

It is also worth noting that studies of long-term wealth-effects may suffer from methodological problems.⁵⁸ Due to the passage of time, it is difficult for a study to isolate the takeover effect from other events which occur in the years subsequent to the acquisition.⁵⁹

Conclusions on the benefits of hostile takeovers

It was stated above that hostile takeovers have two classically stated benefits. Firstly as a means of disciplining management and secondly, as a means of creating wealth by exploiting synergies between the target and acquirer.

On the first of these benefits, the empirical evidence suggests that hostile takeovers are not used as an observable means of disciplining underperforming management. The fact that a firm is underperforming does not seem to be a factor which makes it more likely to be a target of a hostile bid. Takeovers may still play an *ex ante* role in disciplining management, by threatening replacement if underperformance is perceived, unfortunately it is extremely difficult to quantify the effect of a threat on the market for corporate control.

⁵⁴ T. Loughran, and Vijh, A. (1997), 'Do Long-Term Shareholders Benefit From Corporate Acquisitions?', *The Journal of Finance*, Vol. 52, No. 5, pp. 1765-1790.

⁵⁵ A. Cosh, and P. Guest, 2001, The long run performance of hostile takeovers: UK evidence, *Centre for Business Research Working Paper* 215.

⁵⁶ *Ibid* at p28.

⁵⁷ *Ibid* 55 at p28-29.

⁵⁸ M. Jensen, and R. S. Ruback, 1983, The market for corporate control: The scientific evidence, *Journal of Financial Economics* 11, 5-50.

⁵⁹ *Ibid* 6 at p15.

When considering the wealth-effects for the short-term, the empirical literature is unanimous. Studies show that hostile takeovers create wealth in the aggregate. Bidder and target shareholders combined receive positive abnormal returns, however this is due to the substantial premium received by the target shareholders. Bidder shareholders on the other hand see either small negative returns or returns indistinguishable from zero. Evidence of long-term bidder wealth changes are less conclusive however. Some studies indicate small but positive abnormal returns for bidder shareholders, while others show small but negative returns. Once again however, when the initial target shareholder premium and the bidder shareholder returns are combined, they are positive in the aggregate.⁶⁰

The bottom-line is that hostile takeovers are indeed "basically beneficial", however the extent of these benefits should not be overestimated. In particular the disciplining theory of hostile takeovers does not seem to hold much weight and the wealth-creation of hostile takeovers is captured largely by the shareholders of the target, instead of being evenly distributed.

Thus, it can be questioned whether a pro-takeover regime is the correct approach when it comes to crafting takeover regulation. The BNR and BTR are both designed to facilitate hostile takeovers, and are key pillars of a pro-takeover regime. Yet the evidence shows that the benefits they provide are perhaps not as strong as many commentators and legislators would argue. Is the fact that, on average, takeovers are beneficial, a good enough reason to adopt a pro-takeover regime?

Other observers would answer this question in the negative. Proponents of this view argue that a takeover regime should be restrictive - in other words that the BNR and BTR have no place in the legislation. The arguments of those who take this position will be considered in the next section. Put differently, it will evaluate the economic benefits of a takeover regime without the BNR and BTR, i.e. a regime that is takeover restrictive.

2.4 The benefits of a takeover restrictive regime

A takeover restrictive regime would allow managers to raise takeover defences without getting majority approval from the shareholders, effectively giving the management the decision of whether a takeover succeeds. Some who advocate this view, argue that hostile takeovers can be a disruptive influence on well-functioning companies.⁶¹ They argue that takeovers can encourage short-termism as opposed to long-term commitments to

⁶⁰ "The combined abnormal return over both time periods consists of the weighted average of the target announcement returns and the bidder overall returns. In hostile takeovers, the return is 5.4%" Cosh and Guest, see n55 above at p25.

⁶¹ M. Lipton, *Corporate Governance in the Age of Financial Corporatism*, 136 U. Pa. L. REV. 1 (1987) 18-20

shareholder value.⁶² Along this line of reasoning, it has been put forward that some takeovers may result in an undesirable "breach of trust" between management and employees.⁶³ According to Becht,

*"if employees (or clients, creditors and suppliers) anticipate that informal relations with current management may be broken by a new managerial team that has taken over the firm they may be reluctant to invest in such relations and to acquire firm specific human capital. They argue that some anti-takeover protections may be justified at least for firms where specific (human and physical) capital is important."*⁶⁴

Another view is that takeover defences are beneficial because they allow the target board to resist the initial bid, using the defences as a bargaining tool to get the bidder to revise, and therefore raise, the bid premium, benefitting the target shareholders.⁶⁵

These views show that in certain circumstances allowing the target board discretion to create takeovers defences may be desirable. Managers are required to act in the best interests of the company, however when facing a takeover, this often creates a severe conflict of interest. The management best interests and the company's best interests can sharply diverge. Often their own performance and plans are brought into question and their jobs are in jeopardy. Their motives for rejecting the bid may be driven by self-interest, protecting their position and reputation rather than maximising the value of the company for the shareholders.⁶⁶ It has also been pointed out that managers may be cognitively biased, being reluctant to acknowledge their mismanagement and explaining bad strategy as market misvaluation.⁶⁷ A combination of self-interest and cognitive bias can lead to managerial hyperopia. They may honestly (in the sense that cognitive biases are not intentional)⁶⁸ but incorrectly believe that their view of the company value will eventually be proven right, despite temporary underperformance.⁶⁹

⁶² Ibid 1 at p3.

⁶³ A. Shleifer., Summers, L.H. (1988). "Breach of trust in hostile takeovers". In: Auerbach, A.J. (Ed.), Corporate Takeovers: Causes And Consequences. National Bureau of Economic Research Project Report series. University of Chicago Press, Chicago and London.

⁶⁴ Ibid 25 at p851.

⁶⁵ R. Comment, Schwert, G.W. "Poison or placebo? Evidence on the deterrence and wealth effects of modern antitakeover measures". Journal of Financial Economics 39 (1995) 3–43.

⁶⁶ Ibid 8 at p21.

⁶⁷ Ibid 1 at p10.

⁶⁸ L Festinger, A Theory of Cognitive Dissonance (1957). Their bias may be due to seeking more psychologically supportive reasons for their personal failure.

⁶⁹ Ibid 1 at p10.

The markets recognise this hyperopia. By adopting takeover defences, managers are often perceived to be entrenching themselves, insulating their positions from a hostile bid. The market often reacts negatively to this, resulting in a fall in the share price. Numerous event studies have been undertaken on the wealth effects of this and generally that the adoption of takeover defences results in a negative impact on firm value.⁷⁰ While it is true that sometimes management uses takeover defences as a bargaining tool to increase the bid premium their shareholders receive, in the majority of instances this is not the case. The latest data⁷¹ shows that the net effect of the adoption of takeover defences is negative, suggesting the entrenchment effect is greater than bargaining effect.⁷²

While the aggregate result may be negative, an interesting study undertaken by Cotter et al, compares between target firms with independent boards⁷³ and target firms where boards are 'captive'.⁷⁴ They found that shareholders of target firms with independent boards receive premiums that are 23% higher than for targets with more captive boards even when controlling for the presence of anti-takeover devices. This suggests that independent boards are more ready to use anti-takeover devices to the advantage of target shareholders than a more captive board.⁷⁵

Conclusions on the benefits of a takeover restrictive regime

It is accepted that in certain circumstances, allowing management to decide on whether a hostile takeover succeeds can have its benefits. In some scenarios, management may wish to commit to a long-term strategy and make specific investments in human capital, and a hostile bid would disrupt what may be efficient long-term plans. In addition, the study by Cotter et al, above, showed that in some companies with certain characteristics (in this case the independence level of the board) management can use takeover defences to get the best price for their shareholders.

⁷⁰ Ibid 25 at p883.

⁷¹ P. Gompers, Ishii, and Metrick, 'Corporate Governance and Equity Prices' Quarterly Journal of Economics, Vol. 118, No. 1, pp. 107-155, (2003). Available at SSRN: <http://ssrn.com/abstract=278920>

⁷² This is corroborated by comparisons of announcement effects of anti-takeover amendments with a larger bargaining component relative to devices where entrenchment is likely to be prominent. See G. Jarrell, Poulsen, . (1987). "Shark repellents and stock prices: the effects of antitakeover amendments since 1980". Journal of Financial Economics 19, 127–168.

⁷³ An independent board member was brought in from outside the company. Because an independent outside director has not worked with the company for a period of time (typically for at least the previous year), he or she is not an existing manager and is generally not tied to the company's existing way of doing business.

⁷⁴ A captive board is more like 'rubber stamp assembly' that does not check and balance the CEO and management, often because the CEO has a lot of influence over the choice of directors. See Becht, n25 above at p859.

⁷⁵ J.Cotter., Shivdasani, A., Zenner, M. (1997). "Do independent directors enhance target shareholder wealth during tender offers?" Journal of Financial Economics 43, 195–218.

Overall however, the negatives of managerial self-interest outweigh the benefits of allowing management to decide on takeovers. The "great majority of academic lawyers" support this view,⁷⁶ which is also supported by the empirical evidence, showing that the net effect of the adoption of takeover defences has a negative impact on firm value.

2.5 An unbiased (neutral) takeover regime

The economic analysis in the previous sections has demonstrated that hostile takeovers are wealth-creating in the aggregate, and that takeover defences have a net negative impact on firm value. Therefore, if the choice was simply between a pro or anti-takeover regime, the empirical evidence would counsel in favour of a pro-takeover regime. Following this logic, *mandatory* Board Neutrality (BNR) and Breakthrough (BTR) rules within the European Union would be desirable.

More recently however, some commentators have rejected a categorical 'pro' or 'anti' takeover stance and instead advocated a more neutral approach. The basis for this is simple. While hostile takeovers may be wealth-creating in the aggregate, any individual observation can either be wealth-creating or wealth-destructive. Instead of facilitating takeovers in general through a mandatory BNR and BTR, a more efficient regime would promote the wealth-creating takeovers, while impeding those which are wealth-destructive.

It has been suggested that the means to achieve this is through a 'horizontal subsidiarity' approach.⁷⁷ Enriques et al point out that any individual companies' exposure to a takeover is efficient or inefficient depending on a variety of factors. These factors are sensitive to change and will differ from industry to industry, current conditions of the relevant industry, the stage of the firm's lifecycle, etc. Thus, a 'one size fits all'⁷⁸ approach applied by a Member State to all companies registered on its stock exchange will lead to inefficiencies. Some of those companies in its jurisdiction may benefit from being able to raise takeover defences, while others will be most efficient under a pro-takeover regime created by the BNR and BTR.

Therefore, a 'horizontal subsidiarity' approach would dictate that regulation of takeovers should defer the choices made at the level best suited to make a nuanced assessment of the

⁷⁶ M. Wachter, Takeover Defense When Financial Markets Are (Only) Relatively Efficient, University of Pennsylvania Law Review, Vol. 151, No. 3 (Jan., 2003), pp. 787-824

⁷⁷ Ibid 1 at p3.

⁷⁸ See *n13, above* for why a 'one size fits all' approach is not an option in the EU. See also Clarke, B. (2009a) 'The takeover directive: is a little regulation better than no regulation?', *European Law Journal*, Vol. 15, No. 2, pp.174–197.

particular circumstances.⁷⁹ In other words, it should be the individual companies themselves, rather than the Member States, which decide their own level of contestability, as they are best placed to decide which regime would be suit them most efficiently. How the BNR and BTR could be drafted to support such an 'unbiased' regime will be the topic under consideration in chapter 5.

2.6 Conclusion

This chapter has looked at the empirical evidence surrounding the wealth-effects of hostile takeovers (and friendly takeovers comparatively). The purpose of this has been to draw a number of conclusions that will enable the crafting of an efficient regime later in the thesis, specifically considering if the BNR and BTR are efficient in their current form and if they should be altered.

The conclusions reached are as follows. Firstly, that the 'disciplining' effect that many legal commentators attribute and give weight to as a benefit of a hostile takeover, does not seem to have a strong basis in the empirical evidence. As Cosh and Guest conclude, "the findings on hostile takeovers provide little evidence that the U.K. market for corporate control functions as an effective disciplinary device for underperforming companies."⁸⁰ Therefore, one should be careful not to argue this effect as a strong benefit of hostile takeovers.

Secondly, it is concluded that the aggregate wealth-effects of hostile takeovers are positive for targets and bidders combined, in both the short and long-term. Thirdly, the adoption of takeover defences is concluded to have a negative impact on firm value, suggesting the markets view defences primarily as a means of managerial entrenchment. The importance of these two conclusions will be discussed in greater detail in chapter 5, but for now it suggests that a pro-takeover regime is the most desirable 'default' regime, which companies can then choose to opt-out of, if their individual situation warrants it.

Finally, it has been shown that in some circumstances, usually where the majority of the Board is independent, that takeover defences can be used in an efficient way, to raise the premium received by the target shareholders, rather than for managerial entrenchment. This once again enforces the logic behind an unbiased regime, which will allow an individual company to decide what constitutes an efficient level of contestability for itself.

Chapters 3 and 4 will discuss the BNR and BTR respectively. It will look at their effectiveness and current application under the law, before chapter 5 will build on the

⁷⁹ Ibid 1 at p3.

⁸⁰ Ibid 55 at p31.

empirical evidence in this chapter and the work in chapters 3 and 4 to consider how the rules could be drafted into an efficient, unbiased regime.

Chapter 3 – The Board Neutrality Rule Under Article 9

Chapter Introduction

This chapter will analyse the implementation of the Board Neutrality Rule (BNR) under Article 9 of the Directive. It will first consider the aims of the BNR, by looking at what the Commission hoped to achieve with the rule. Next it will look at how the BNR operates in practice, and what effect the optionality and reciprocity clauses found in Article 12 of the Directive have. The choices this provides both at the Member State and company levels will then be laid out and explained, before the actual transposition choices that the Member States and companies have made, will be analysed. Once the impact of the implementation has been fully assessed, the question of whether the BNR can be called a success will be answered, and finally conclusions will be drawn on whether a reform is necessary.

3.1 Aims of the Board Neutrality Rule

When considering the objectives of the Board Neutrality it is useful to frame it within the general aims of the Takeover Directive as whole. The principle objectives of the Commission when crafting the Takeover Directive was to promote the integration of the national economies of the Member States comprising the "single market" and to enhance the competitiveness of European industries against non-European rivals by facilitating takeover bids.¹ In its 2002 proposal, the Commission wrote,

*"Under the circumstances, the Commission considers it essential to provide a European framework for cross-border takeover bids as part of the Financial Services Action Plan. Such transactions can contribute to the development and reorganisation of European firms, a key condition for withstanding international competition and developing a single capital market"*²

Furthermore, the 2005 Financial Services White Paper stressed the need to,

"consolidate dynamically towards an integrated, open, inclusive, competitive, and economically efficient EU financial market" and to *"remove the remaining economically significant barriers so financial services can be*

¹ P. Davies, E. Schuster, & E. van de Walle de Ghelcke, *The Takeover Directive as a Protectionist Tool?* in *Company law and economic protectionism: New challenges to European Integration* (Ulf Bernitz & Wolf-Georg Ringe eds. 2010). p105.

² Commission of the European Communities, *Proposal for a Directive of the European Parliament and of the Council on Takeover Bids*, COM (2002) 534 final, Brussels, October 2002. p3.

*provided and capital can circulate freely throughout the EU at the lowest possible cost."*³

According to Davies⁴ although this rationale was supported by the familiar arguments about providing a 'level playing field' and enhancing legal certainty, he concludes that the Commission's 2002 Proposal for the Directive, or at least the sections of it that were to prove controversial, can only be explained on a rationale of facilitating bids and integrating the European capital market.⁵ Further, the two provisions of the Directive which facilitate bids to the greatest extent are the BNR and BTR. However the decision to adopt the Directive with the proviso that these two rules be optional rather than mandatory was bitterly opposed by the Commissioner responsible for the proposal, who claimed that the optional nature of the new rules meant the Directive was "not worth the paper it was written on."⁶ It is therefore clear that the competitiveness rationale, achieved by the facilitation of bids, was the dominant one in the Commission's mind.⁷ By preventing management from taking action which would frustrate a takeover bid for the target company without obtaining shareholder approval, a mandatory BNR would have had a significant impact on the facilitation of bids. Since takeover bids are seen as "basically beneficial"⁸ and Chapter 2 of this thesis evidenced that they are efficient in the aggregate⁹ it can be concluded that the aim of the BNR within the Directive is to increase the competitiveness of the European capital markets by increasing the contestability of corporate control.

3.2 Operation of the Board Neutrality Rule

Takeover defences can be broadly divided into two distinct categories, pre-bid and post-bid. The BNR as found in Article 9 of the Directive is related to post-bid defences, which are applied once the target company has become the subject of a takeover bid. The following table sets out a number of common defences of this type:

³ White Paper - Financial Services Policy 2005-2010 {SEC(2005) 1574}

⁴ Ibid 1 at p106

⁵ Not all elements of the Takeover Directive are aimed at facilitating bids, the Mandatory bid rule and Sell-out rule for example are both generally accepted to reduce the likelihood of a takeover occurring. However both these rules can be seen as being in line with the 'competitiveness rationale' insofar as they prevent inefficient takeovers.

⁶ V Edwards, "The Directive on Takeover Bids - Not worth the Paper It's Written on?" (2004) 1 European Company and Financial Law Review 416.

⁷ Ibid 1 at p106.

⁸ High Level Group of Company Law Experts, *Report on Issues Related to Takeover Bids*, Brussels 10 January 2002. The High Level Group further considered that a mechanism for takeovers was basically beneficial because of the synergy gains and disciplining function that takeovers provided, stating that these views 'formed the basis of the Directive'.

⁹ See chapter 2 of this thesis, which concluded that both hostile and friendly takeovers were efficient in the aggregate, largely due to the large premium received by target shareholders.

Defensive Action

White Knight	A target company seeks an alternative merger or acquisition partner, who is on friendly terms with the target management, to buy a majority block of shares.
White Square	Similarly to the White Knight defence, the target company in this scenario seeks an alternative partner who is on friendly terms to acquire a minority block of shares in the target.
Capital Increase	Increases the equity capital of the company, either through the issue of new shares or by raising the par value of existing equity making a takeover more expensive.
Debt Increase	The company takes on debt to make itself a less attractive target.
Acquisition of Assets	The company acquires assets which may be undesirable from the bidder's perspective.
Sales of Assets (Crown Jewels)	This constitutes the target company entering into a sale of its most attractive assets to a friendly third party, thereby making itself a less appealing target.
Pac-Man Defence	The target company launches a takeover bid of the original acquirer. Often heavily leveraged.
Issue of Warrants ('Poison Pills' and Shareholder Rights Plan)	The target company facilitates the issue of shares to its shareholders at a discount, in an attempt to dilute the acquirer's control.

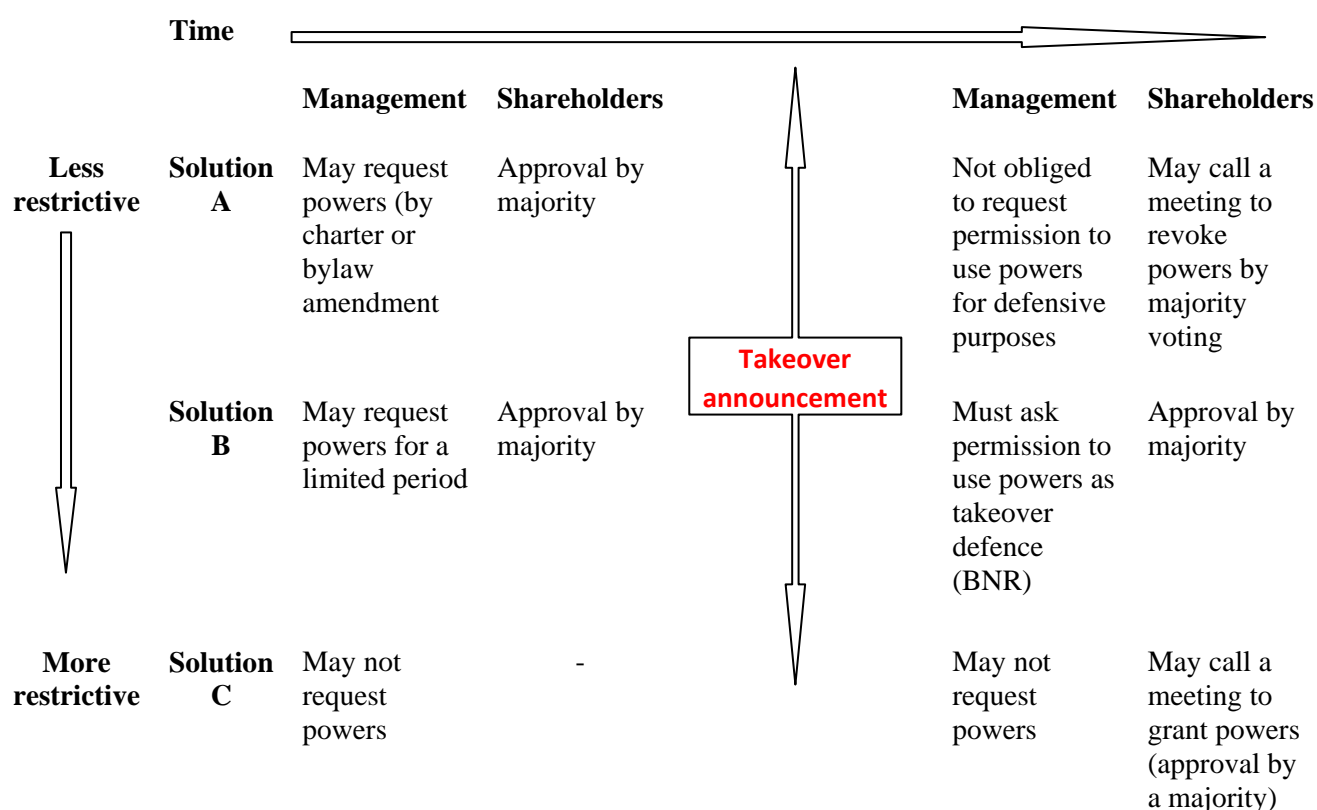
The BNR provides that the board of the target company must obtain post-bid authorisation from the shareholders' meeting before taking action which would result in the frustration of a bid, with the explicit exception of seeking a 'white knight'.¹⁰ Where a company has a two-tier board structure, the rule applies to both the management and supervisory board.¹¹ By requiring post-bid shareholder authorisation for the adoption of defensive measures, the BNR is a bright-line rule which shifts decision making from the board to the shareholders. As

¹⁰ See Article 9 (2).

¹¹ H. Fleischer, 'The Responsibility of the Management and its Enforcement' in G. Ferrarini and others (eds), *Reforming Company and Takeover Law in Europe* (OUP, Oxford 2004) 373. Such two-tiered board structures are common in Germany.

such, the rule does not prohibit defensive measures, but instead subjects them to explicit shareholder approval after an actual bid has been made.¹² Rather than being a substantive provision, it is a procedural rule and therefore benefits from being analysed within the context of corporate law as a whole.¹³ In other words, the procedural arrangement provided for by the BNR is one of a number of possible solutions which allocate decision-making authority on adopting defensive measures. Decision making power ultimately resides with the shareholders but may be temporarily or indefinitely vested with the management, where temporary powers usually only require majority approval while indefinite powers would need a qualified majority.¹⁴ The figure below shows three different procedural frameworks for how a company can adopt defensive measures, with the BNR represented by the middle solution, B.

Figure 1: Procedural Rules for the adoption of defensives measures



Source: Based on C. Clerc et al, *Legal and Economic Assessment of European Takeover Regulation*

¹² C. Clerc et al, *Legal and Economic Assessment of European Takeover Regulation* (December 11, 2012). CEPS Paperbacks at p179.

¹³ M. Goergen, M. Martynova and L. Renneboog (2005), *Corporate Governance Convergence: Evidence from takeover regulation*, European Corporate Governance Institute (ECGI) Law Working Paper No. 33, ECGI, Brussels, April.#

¹⁴ Ibid 12.

The three solutions shown above are not an exhaustive set, but are useful to frame the solution provided for by the BNR, with solution A representing the least restrictive regime while C is the most restrictive.

The above figure also illustrates an advantage of the BNR, namely that it allows shareholders to reap the benefits of an advance approval of share issues (a power commonly used to defend the company) while avoiding the costs associated with such an action.¹⁵ The reasoning is as follows. The BNR requires the board of the target to seek authorisation for defensive measures once they have received information about the bidder's decision to launch a bid.¹⁶ In such a scenario, where a target board asks permission for defensive measures it is perfectly well understood by the shareholders that such powers will be used to 'defend' the company. Similarly when the bid has not yet been officially communicated to the target Board but rumours of a potential bid are widespread, the target shareholders equally understand that a board's request for additional powers is for the purpose of 'defending' the company against the expected imminent bid. Therefore, where a bid is official or expected, the shareholder's decision of whether to grant additional powers hinges on the expected impact of the anticipated defensive measures on the share price - i.e. trading off the benefit of obtaining a higher premium via the increased bargaining power of the board versus the risk of management setting-up entrenchment-driven defences.¹⁷

Thus, where the company is facing a hostile offer or one is perceived to be imminent, the shareholders can weigh the risks against the benefits and make an informed decision. However, problems arise when the company is not facing a bid, whether perceived or actual. This is down to the fact that the powers most commonly used to "defend" the company can typically be used to multiple purposes, many of which clearly lie in the interest of the shareholders¹⁸ and are often granted when the company is not perceived to be a potential target. In such a scenario, shareholders may grant management powers for the purpose of quickly raising finance for the company (e.g the authority to issue new shares), but inadvertently pave the way for an opportunistic management to entrench themselves should the company become a target further down the line. This problem is summed up by Davies et al, "shareholders may have to accept the cost of enhancing managerial discretion in relation to a bid in order to reap the benefits arising from management's increased discretion

¹⁵ Ibid 1 at p111.

¹⁶ Takeover Directive Article 9(2) and 6(1). Under 9(2) the Member States can also require that such authorisation from the board is obtained at an earlier stage, e.g "as soon as the board of the offeree company becomes aware that a bid is imminent." This is the case in the UK under r21 of the City Code.

¹⁷ Ibid 1 at p111.

¹⁸ Ibid

in a non-takeover scenario."¹⁹ This would be the case in a procedural arrangement such as solution A (Figure 1, above) however this problem can be overcome by the BNR.

By explicitly requiring shareholder permission post-bid, any pre-bid powers will need to be effectively renewed once a bid is launched. The rule ensures that management cannot use additional powers they had been granted for purposes other than that which the shareholders had originally intended. Since investors face perception bias and information asymmetries compared to management, only requiring pre-bid authorisation as in solution A does not sufficiently protect shareholders,²⁰ but this problem is overcome by the BNR, as in solution B. Solution C meanwhile does not suffer from this issue but lacks flexibility, preventing management from requesting powers that may legitimately benefit the shareholders.

It is of course possible for shareholders to grant temporary powers that are qualified (i.e. disapplied if a bid materialises) or to call a meeting to remove said powers, however the former presupposes a sophisticated shareholder body and the latter relies on the shareholders overcoming their collective action problems and rational apathy. In short, the BNR is an efficient way of allowing shareholders to realise the benefits while avoiding the costs of advance approval of share issues.²¹

3.3 Optionality and Reciprocity

The BNR (and BTR) are greatly complicated by a system of optional choices at both the Member State and Company level, due to the introduction late in the day of Article 12 of the Directive.²² The two rules were the cornerstones of the Commission's strategy for creating a 'level playing field'²³ in Community takeover law yet remained the most contentious parts of the Directive.²⁴ Chapter 1 of this thesis has detailed the difficult path to adoption that the Directive took, showing that there was not sufficient political will among the Member States to agree to mandatory rules which would harmonise takeover law, resulting in compromise that is Article 12.

¹⁹ Ibid

²⁰ Marccus Partners, *The Takeover Bids Directive Assessment Report*, p301 available at http://ec.europa.eu/internal_market/company/takeoverbids/index_en.htm

²¹ Ibid 1 at p111-112.

²² Winter, J. 2004. 'EU Company Law at the Cross-Roads'. In G. Ferrarini, K.J. Hopt, J. Winter and E. Wymeersch (eds.). *Reforming Company Law and Takeover Law in Europe*. Oxford/New York: Oxford University Press p18.

²³ High Level Group of Company Law Experts, *Report on Issues Related to Takeover Bids*, Brussels 10 January 2002.

²⁴ M. Gatti, "Optionality Arrangements and Reciprocity in the European Takeover Directive" (2005) 6 *European Business Organization Law Review* 556.

Article 12 (1) provides that "Member States may reserve the right not to require companies... to apply Article 9(2) and (3) and/or Article 11." This creates a choice at the Member State level allowing for the State in question not to apply the BNR and/or BTR. The Directive further requires that where a Member State employs the opt-out provision, they must provide a reversible option for companies to opt 'back in'. This company-level decision is to be taken by the shareholders in accordance with the rules applicable in that jurisdiction for adopting changes to the companies' articles of association.²⁵

Though the Member States' choice of whether or not to apply the rules is unfettered, the language used to express the option clearly shows that opting-out was not the desired outcome envisioned by the drafters.²⁶ It was hoped that Board Neutrality would be 'default' regime. According to Jaap Winter, the choice of being subject to the rules "sets the benchmark", and rather than forcing companies into them it was instead hoped that market pressures would provide the incentives for companies to adopt the them.²⁷ In summary, the optionality clause in Article 12 allows Member States to choose not to require companies to apply the BNR and BTR, whilst allowing companies the opportunity to 'opt back in' should they so choose.²⁸

Reciprocity

In addition to optionality, Article 12 also introduces a novel concept in takeover law which can be found in subsection 3 - reciprocity. Described by Davies as one of the "oddest" results of the compromise that led to the adoption of the Directive²⁹, it concerns the question of whether a company is subject to the BNR (and/or BTR), dependent on the identity of the bidder. Under Article 12(3) Member States are allowed to let companies subject to the BNR and/or BTR, refrain from applying those rules if the bidder is themselves not subject to them.

As with the optionality clause, reciprocity creates choices at both the Member State and company levels. If a Member States chooses to allow Companies to use the reciprocity exception, then the company through its shareholders can authorise management to take defensive actions which would otherwise be prohibited by the BNR. Such authorisation must be made no earlier than 18 months before the bid is made public by the offeror company.³⁰

²⁵ Takeover Bids Directive, Article 12(2).

²⁶ Ibid 1 at p126.

²⁷ Ibid 22. See also B. Clarke "Articles 9 and 11 of the Takeover Directive (2004/25) and the Market for Corporate Control" [2006] *Journal of Business Law* at p372.

²⁸ Ibid, B. Clarke nr27 text above.

²⁹ Ibid 1 at p126.

³⁰ Takeover Bids Directive, Article 12(5).

The genesis of the reciprocity exception can be found in the concerns expressed by the Member States after turning down the Commission's 2001 proposal.³¹ One of these concerns was that a mandatory BNR for European firms would put them on an unlevelled footing with companies outside the EU, in particular US firms which can typically employ strong defensive measures. This concern was addressed by The High Level Group in the Winter Report. Notwithstanding that they were of the opinion that this concern would not manifest,

*"the Group believes its proposals would not give American companies an unfair advantage when trying to exploit the European internal market... as compared with the conditions which apply for European companies"*³²

they nevertheless suggested an early-stage form of reciprocity; that Board Neutrality would only apply to European firms targeting other European firms, so as not give the US an 'advantage.'³³ However this suggestion was put forward by the Group presupposing a mandatory BNR. Instead the reciprocity exception has been attached to an optional rule, substantially complicating the whole framework of the Directive and directly conflicting with the aim of harmonisation.³⁴

Reciprocity was drafted at a late and contentious stage on the Directive's long path to adoption and it is perhaps because of this it was not given the full consideration it required. Consequently it has drawn criticism from a vast range of commentators³⁵ who have pointed out multiple issues with the clause from both theoretical and practical standpoints. With regards to the former, Becht has noted two main drawbacks.³⁶ Firstly, that the rule is under-inclusive in pursuing a level playing field, as the mere fact that a company is subject to the BNR and/or the BTR does not automatically make it contestable. Secondly, reciprocity in takeovers unduly restricts the number of potential offerors, by artificially reducing the pool of potential bidder companies to those which are themselves open to hostile bids.³⁷ This not only decreases overall takeover activity but reduces the scope for instances of competing bids, to which the empirical evidence attaches higher bid premia. As such, the exception

³¹ M. Becht, 'Reciprocity in Takeovers' (October 2003). ECGI - Law Working Paper No. 14/2003. Available at SSRN: <http://ssrn.com/abstract=463003>.

³² Ibid 23 at p42.

³³ Ibid 23 at p42.

³⁴ Ibid 1 at p126-127.

³⁵ See e.g Becht 35 above,

³⁶ Ibid 31.

³⁷ B. Clarke "Articles 9 and 11 of the Takeover Directive (2004/25) and the Market for Corporate Control" [2006] *Journal of Business Law* at p373.

weakens the BNR by reducing its facilitating effect and allows for less bidder-friendly companies.

From a practical standpoint, Davies has pointed out that there 'unsolved questions' concerning the scope of the reciprocity exception³⁸ and different commentators have expressed alternative views on the correct application.³⁹ It is hardly surprising therefore that a recent publication from the European Company Law Experts (ECLE) contended that reciprocity is both "flawed" and "superfluous" and recommended abolishment would be a suitable course of action.⁴⁰ It appears that the reciprocity exception found in the Directive was rooted in political policy concerns rather than sound economic rationale. Chapter five of the thesis will consider in greater detail the problems of reciprocity when suggesting reforms, but for now it is time to turn the focus of attention to the Member States choices in transposing the Directive.

3.4 Transposition - the decisions made

Such a complex system of options available to the Member States has made transposition of this particular Directive far more significant than usual. The next logical step is to analyse how the Member States have implemented the BNR, and compare this with the pre-implementation status in order to see if the Directive has brought about change.

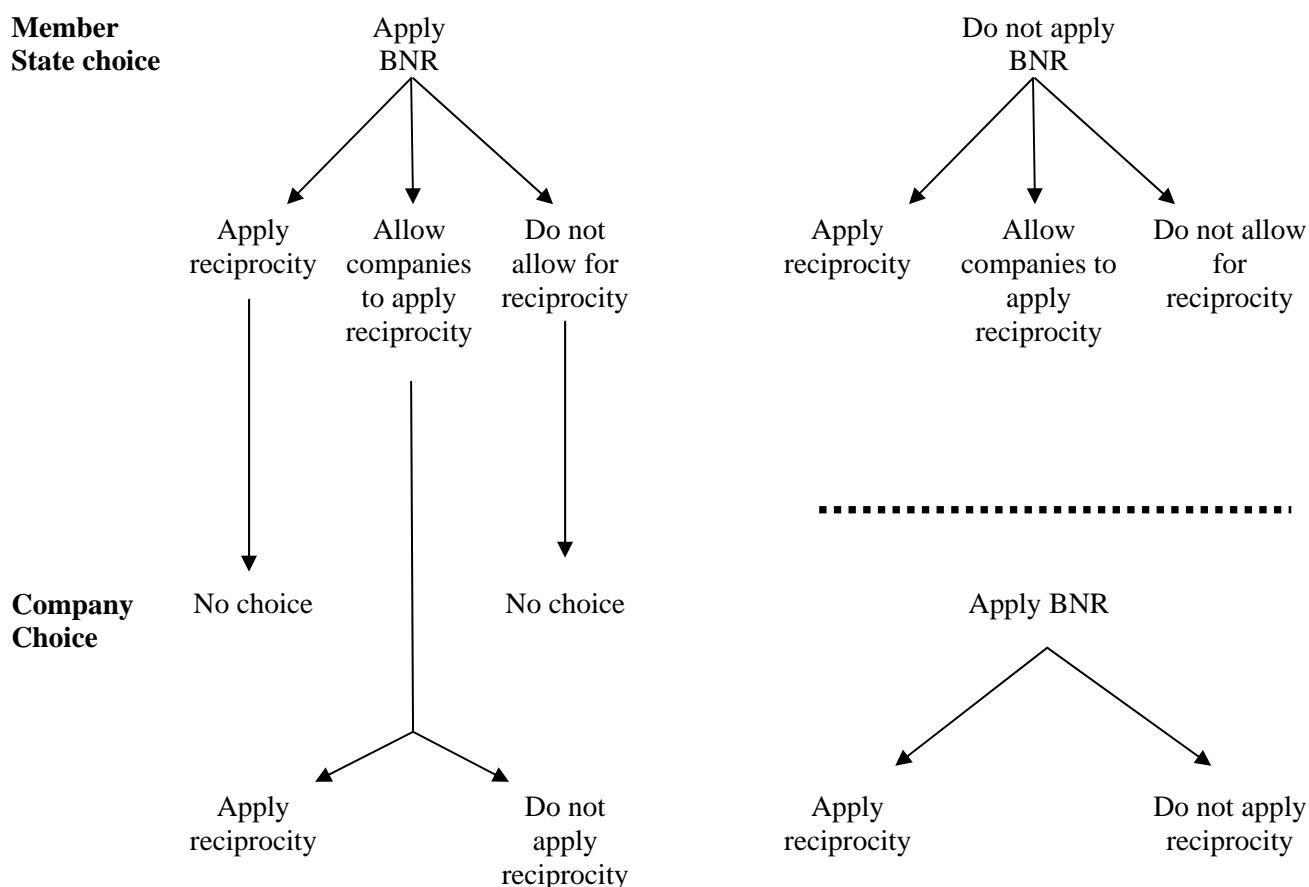
The following diagram summarises the choices available at both the Member State and Company level under the Directive.

³⁸ Ibid 1 at p127.

³⁹ For arguments that differ from Davies et al, see e.g J Rickford, "The Emerging European Takeover Law from a British Perspective" (2004) 15 European Business Law Review 1379.

⁴⁰ Böckli, Peter and Davies, Paul L. and Ferran, Elis and Ferrarini, Guido A. and Garrido Garcia, José M. and Hopt, Klaus J. and Pietrancosta, Alain and Pistor, Katharina and Skog, Rolf and Soltysinski, Stanislaw and Winter, Jaap W. and Wymeersch, Eddy, Response to the European Commission's Report on the Application of the Takeover Bids Directive (November 30, 2013). University of Cambridge Faculty of Law Research Paper No. 5/2014.

Figure 2: Choices Created by the Directive



Source: Adapted from Marccus Partners, *The Takeover Bids Directive Assessment Report*

In certain scenarios, choices made at the Member State level may lead to an absence of choice at the company level.⁴¹ Therefore the transposition choices made by the Member States will be addressed first. Davies et al have carried out a comprehensive study on the transposition of the BNR and their data will be used below.⁴²

The following table shows which States transposed the BNR with or without the reciprocity exception. Further, while it has been claimed that the transposition of the BNR is a "relative success"⁴³ as a result of the relatively high number of Member States that transposed the rule, a better indicator of 'success'⁴⁴ is to consider whether transposition of the Directive has brought about material change within Europe with regards to Board Neutrality. In other words, is the application of the BNR more widespread pre or post-directive?

⁴¹ For example, a mandatory BNR without reciprocity would leave no choice available at the company level.

⁴² Ibid 1.

⁴³ Ibid 20 at p35.

⁴⁴ 'Success' from the perspective of the Commission. It will be argued later that complete board neutrality across the EU is not necessarily a desirable outcome. See section, 'Did the Board Neutrality Rule achieve its aims?' below.

To answer this question a scoring system has been used to evaluate whether the Member States have become more or less bidder-friendly (with regards to the BNR). A higher score equates with a higher level of bidder friendliness. It has been calculated as follows. A score of (+3) is given for Member States which apply a mandatory BNR, with a further (+1) added where the Member State has chosen not to allow for reciprocity. This yields the highest score of (+4), representing the most bidder friendly countries which apply a strict BNR, and (0) representing the least bidder-friendly, where the BNR is optional and those companies opting-in may do so on the basis of reciprocity.⁴⁵

Table 1: Member State Choices

Country	Mandatory BNR	Reciprocity	Post-transposition Score	Pre-transposition Score	Difference
Austria	Yes	No	4	4	0
Bulgaria	Yes	No	4	4	0
Cyprus	Yes	No	4	0	+4
Czech Republic	Yes	No	4	4	0
Estonia	Yes	No	4	4	0
Finland	Yes	No	4	0	+4
Ireland	Yes	No	4	4	0
Latvia	Yes	No	4	0	+4
Lithuania	Yes	No	4	4	0
Malta	Yes	No	4	0	+4
Romania	Yes	No	4	0	+4
Slovakia	Yes	No	4	4	0
Sweden	Yes	No	4	4	0
UK	Yes	No	4	4	0
France	Yes	Yes	3	4	-1
Greece	Yes	Yes	3	4	-1
Portugal	Yes	Yes	3	4	-1
Slovenia	Yes	Yes	3	4	-1
Spain	Yes	Yes	3	4	-1
Italy	No*	Yes	**2	4	-2
Belgium	No	Yes	0	0	0
Denmark	No	Yes	0	0	0
Germany	No	Yes	0	0	0
Hungary	No	Yes	0	4	-4
Luxembourg	No	Yes	0	0	0
Netherlands	No	Yes	0	0	0
Poland	No	Yes	0	0	0

Source: Data taken from P. Davies et al, see nr1 above

⁴⁵ This scoring system has been taken from Davies et al as mentioned above. See Ibid 1 at p29-39.

*Italy has implemented an optional BNR however the default position is reversed, i.e. companies must elect to opt-out of the rule

**The Unique score of (2) given to Italy is explained below.

Firstly it is necessary to explain the result of Italy's score of 2, a result which is formulated differently to the scoring system laid out above.⁴⁶ Italy has altered its national rules regarding the BNR multiple times since the Directive has been introduced. Originally both the BNR and BTR were implemented as mandatory (quite an astonishing result in the case of the BTR), but following the financial turmoil of 2008, both rules were altered to be optional, with companies able to opt-in but the default being that neither applied.⁴⁷ This was altered again, but in a unique way in 2009. The BNR (but not BTR) became the default position for companies, from which they could choose to opt-out of, with reciprocity also remaining an option.⁴⁸ As a result, Italian companies will be subject to a BNR unless they amend their articles of association to opt-out.

An optional BNR with reciprocity would usually result in a score of (0) but by reversing the default so that companies must opt-out, Italy has created a significantly more bidder-friendly corporate landscape, resulting in a higher score of (2). The reason for this is that Italy's implementation, though still optional, results in a much more widespread use of the BNR. Under the typical mechanism, the body standing to gain from the BNR (i.e. the shareholders who wish to capture restructuring and disciplinary benefits)⁴⁹ face significant hurdles⁵⁰ in securing an opt-in to the BNR. Collective action problems encountered by dispersed shareholders are compounded by the fact that opt-in typically requires a supermajority vote.⁵¹ In short, the opt-in provision for the BNR places the burden to act on the group least equipped to do so.⁵² Italy's implementation however reverses the status quo, so that the burden to opt-out is placed on the management, for who no such collective action problem exists. Furthermore the 'supermajority requirement' problem mentioned above is alleviated by reversal - only 33% of the shareholders is sufficient to keep the BNR in place by blocking

⁴⁶ The system only allows for 0, 1, 3 and 4 as possible results.

⁴⁷ A. Paces, *Rethinking corporate governance: The law and economics of control powers* (Routledge 2013) at p401.

⁴⁸ See Legislative Decree no. 146, art. 1(3) 25th September 2009.

⁴⁹ *Ibid* 1 at p131.

⁵⁰ As evidence of these difficulties, to date, not a single European company has chosen to opt-in to the BNR. There are however several instances where the reverse is successful, i.e. companies opting out. See below.

⁵¹ Article 12(2) of the Directive requires that the opting-in decision be taken "in accordance with the rules applicable to amendment of the articles of association".

⁵² G. Hertig and J. McCahery, 'Company and takeover law reforms in Europe: Misguided Harmonization efforts or regulatory competition?' (2003) 4 *European Business Organization Law Review* 179.

an opt-out, as opposed to 66% typically required to put a BNR in place under the typical regime.⁵³

However, the system in Italy never yields a more bidder-friendly outcome than a country scoring (3) which has in place a mandatory BNR, therefore a score of (2) seems to adequately reflect the position of Italy's new rule in terms of bidder-friendliness.

Has the Directive brought about change?

The table above compares the position of Member States pre and post-bid. In a 2012 report, the Commission stated that it "could be concluded... the Board Neutrality rule is a relative success"⁵⁴ based on the reasonably high amount of Member States choosing to apply a mandatory BNR. However it is submitted that this is not a suitable metric of success, as it fails to consider if transposition has actually brought about change. An argument could be made that all Member States have moved to a more bidder-friendly position, as all companies in Member States where the BNR is not mandatory are given the option to opt-in, whereas previously they could not commit their management to a non-frustration rule. However, Davies et al contend that the collective action and supermajority problems (discussed above) make this extremely difficult in practice. These difficulties are so great in fact, that they were unable to find a single company which had opted back in, leading them to conclude that an optional BNR does not constitute a move in a bidder friendly direction.⁵⁵

Looking back to the table, it shows that five Member States have moved in a more bidder friendly direction, fifteen have maintained effectively the status quo, and seven have become less bidder friendly.

More Bidder Friendly	Equally Bidder Friendly	Less Bidder Friendly
Cyprus, Finland, Latvia, Malta, Romania	Austria, Bulgaria, Czech Republic, Estonia, Ireland, Lithuania, Slovakia, Sweden, UK, Belgium, Denmark, Germany, Luxembourg, Netherlands, Poland	France, Greece, Portugal, Slovenia, Spain, Hungary, Italy

⁵³ Ibid 1 at p137.

⁵⁴ Report from the commission to the European parliament, the council, the European economic and social committee and the committee of the regions Brussels, 28.6.2012 COM(2012) 347 final. at p8.

⁵⁵ Ibid 1 at p139.

It therefore seems that the implementation of the BNR under the Directive has not had the impact desired by the Commission.⁵⁶ Only five States adopted more bidder-friendly regimes, and it is worthy of note that four out of the five have particularly small capital markets, with Finland being the exception.⁵⁷ In terms of facilitating takeover bids, the transposition of the BNR appears to have contributed very little. One explanation could be that takeover regulation had been on the minds of national legislatures since the boom in the late 1990s⁵⁸ and consequently those Member States which were in favour of Board Neutrality had already adopted rules with the same effect prior to the transposition of the Directive.⁵⁹

However, this does not account for the seven Member States which moved to a less bidder-friendly position post-transposition. For five of these States the shift involved moving from a previously mandatory BNR to a mandatory BNR with reciprocity, while in the remaining two, the shift was more significant, replacing a previously mandatory BNR with an optional one. In these two States however it seems unlikely it was the Directive itself that brought about the change, but rather external market occurrences which triggered the move towards being less bidder-friendly. In the case of Italy, mentioned above, the 2008 financial crisis was the likely cause of the move. For Hungary, it appears that a large hostile bid for a Hungarian company in a sensitive sector from a foreign rival was the causal event.⁶⁰

However, while the Directive is unlikely to be the cause of Italy and Hungary's shifts away from a mandatory BNR, the position may be different with regards to France, Greece, Portugal, Slovenia and Spain, which all weakened their national forms of the BNR by allowing for reciprocity. Prior to the negotiations leading up to the adoption of the Directive there was no concept of reciprocity within European takeover law. Since transposition of the Directive once again required national legislatures to reconsider their positions on the levels of corporate contestability, it was almost inevitable that the renewed policy debate would result in at least some instances of reciprocity being implemented. Given the resurgence in the supporters of economic nationalism this seems even more likely.⁶¹ In other words, transposition of the Directive can be seen as the direct cause of at least five Member States

⁵⁶ 'Directive on Takeover bids implemented in a protectionist way says Commission' (2007) *Company Lawyer*.

⁵⁷ The market capitalisations of the jurisdictions in GBP are Latvia: 1.15bn; Malta: 2.50bn, Cyprus: 6.3bn, Romania: 7.4bn. Collectively these jurisdictions are equal to 1% of the UK market. See Davies et al, *ibid* 1 at p34.

⁵⁸ M. Martynova and L. Renneboog, *Mergers and Acquisitions in Europe*, ECGI Finance Working Paper 114/2006 at p2.

⁵⁹ *Ibid* 1 at p142.

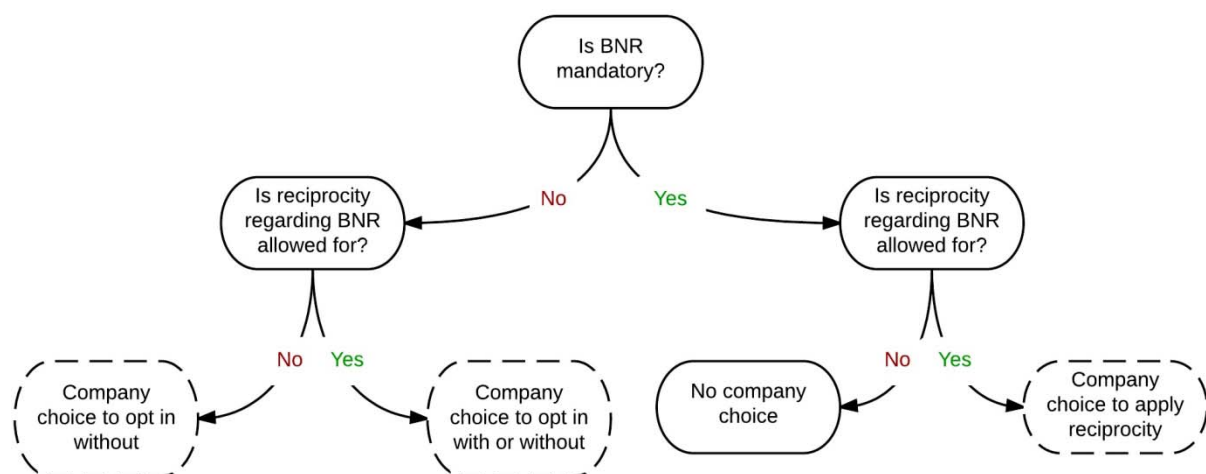
⁶⁰ Act CXVI of 2007 implemented the new regime. Because of the Hungarian company in question, MOL, the law is colloquially referred to as 'Lex MOL'. See Davies, *ibid* 1 at p38.

⁶¹ K. Hopt, 'Obstacles to corporate restructuring: observations from a European and German perspective' in M Tilson et al (eds), *Perspectives in Company law and Financial Regulation* (CUP, 2005).

weakening their rules on Board Neutrality by allowing for a reciprocity exception.⁶² Now that the Member State choices have been considered, it is time to look at the choices available at the Company level, and to what extent they have been utilised.

Company Level Choices

It was discussed above that choices may exist at the company level, dependent on the Member States' implementation, on whether to opt-in to the BNR, with or without reciprocity.⁶³ The following diagram illustrates the potential scenarios:



Source: Based on Davies et al, see *Ibid* 1 above at p26.

It was hoped that companies would choose to opt-in to the BNR where the Member State had not applied it on a mandatory basis.⁶⁴ From the shareholders' perspective, the incentive to opt-in would be to maximise the value of the shares, by securing the disciplinary and restructuring benefits of a takeover. However as discussed above, the supermajority requirement combined with the collective action and rational apathy problems faced by a dispersed shareholder ownership make this outcome extremely difficult to achieve in practice, to the extent that no company has opted back in.

However it could be argued that an incentive exists for management or a controlling shareholder to opt-in to Board Neutrality. Companies having acquisition plans in countries which do not apply a mandatory BNR, may wish to opt-in so as to avoid potential targets

⁶² France, Greece, Portugal, Slovenia and Spain.

⁶³ See section above, entitled, 'optionality and Reciprocity'.

⁶⁴ See text to footnote 27, above.

using the reciprocity exception against them.⁶⁵ However, the potency of this incentive hinges on i) the reciprocity exception being available and ii) companies actually taking up the exception. With regards to i), fourteen Member States in the table above (those scoring 4) do not allow for the reciprocity exception, automatically ruling them out from using it against acquirers thus weakening the incentive. Furthermore, in the seven countries scoring (0) above which allow for reciprocity, no company has opted in to the BNR in the first place, making the reciprocity exception non-existent in those jurisdictions also. This leaves only five countries (those scoring 3) where the incentive has relevance, and out of those, the evidence suggests only French companies have any level of engagement with the reciprocity exception.

It is now time to consider the two instances of company-level decision making: opt-outs under the 'reverse' system in Italy and the use of reciprocity by some French companies.

The situation in Italy has been described above and aligns the implementation of the BNR with the more modern theory that default rules should be crafted against the interests of management.⁶⁶ This places the burden on management (or a controlling shareholder) to act where it is efficient for them to do so, rather than placing it on dispersed shareholders who face coordination problems which in practice prevent them from acting, even where it would be in their best interests.⁶⁷ Management on the other hand has easier access to mechanisms by which the default rule can be altered and because the costs of opting out of a pro-takeover default would only be borne in the presence of offsetting benefits, such a default would be expected to result in opt-outs which were efficient.⁶⁸ This is confirmed by the empirical evidence which shows several Italian companies have chosen to opt-out:

Table 3: Italian Companies which have opted-out of the BNR

Company Name	Market Value (million euro)
Fiat S.p.A	8232
Banca Carige S.p.A	2659
YOOX S.p.A	510
Marcolin S.p.A	273
Tamburi Investment Partners S.p.A	201

⁶⁵ M. Siems, 'The Rules on Conflict of Laws in the European Takeover Directive'. (2004) *ECFR* 1 at p460, footnote 8.

⁶⁶ L. Bebchuk, and A. Hamdani, 'Optimal defaults for Corporate Law evolution' (2002) 96 *Northwestern University Law Review* 489, 513.

⁶⁷ Luca Enriques, Ronald Gilson, Alessio Paces The Case for an Unbiased Takeover Law (with an Application to the European Union) (May 1, 2013). ECGI - Law Working Paper No. 212; Columbia Law and Economics Working Paper No. 450; Stanford Law and Economics Olin Working Paper No. 444. Available at SSRN: <http://ssrn.com/abstract=2258926>.

⁶⁸ *Ibid* at p21.

AcegasAps S.p.A	189
EL.EN S.p.A	52
Mondo Home Entertainment S.p.A	10
Meridie S.p.A	7

Source: Marccus Partners⁶⁹

The other instance of company level decision making can be found in France where, as of 2008, approximately twenty percent of CAC40 companies had applied the reciprocity exception.⁷⁰ Davies et al submit three reasons as to why this has taken place in France, but in no other jurisdictions which allow for reciprocity.⁷¹ Firstly, the French legislature specifically provided for 'defensive warrants'⁷² (*bons Bretons*) as an menu rule, effectively allowing French companies to use reciprocity defensively. Secondly the typical shareholder structure in French companies is significantly less concentrated than other continental European countries (though still much more so than the UK).⁷³ This form of insecure blockholding appears to lend itself to an increased interest in strengthening management against an acquirer, as such a blockholder finds it more difficult to retain control when faced with a bid. Finally, France has a "mini-BTR"⁷⁴ in place which somewhat limits other forms of takeover defences that a company may otherwise be inclined to make use of. Thus, in the absence of the availability of these defences, the added defensive protection from the reciprocity exception becomes a more attractive option.

In summary, while the Commission had hoped that companies would "push for the optional provisions to be applied voluntarily... where Member States chose not to transpose them"⁷⁵ and some commentators had expected this to be the case,⁷⁶ it has simply not happened in practice. The incentive for dispersed shareholders is strong, but the steep hurdles they face in securing an opt-in have prevented the reality from materialising. Conversely, while management or a controlling shareholder would be able to effect an opt-in, the incentives for them to do so are very weak - any acquisition programme would be strengthened against only a relatively small amount of French companies. For these reasons Davies et al consider

⁶⁹ Ibid 20 at p190.

⁷⁰ Herbert Smith Freehills LLP, Overview of defences used by companies listed on the CAC 40 to prevent unsolicited takeover bids, February 2008.

⁷¹ Ibid 1 at pp148-153.

⁷² Commercial Code Arts L233-32.II and L233-33.

⁷³ F. Barca and M. Becht, *The Control of Corporate Europe* (OUP Oxford 2001), see 'Introduction'.

⁷⁴ This form of Mini-BTR prohibits the use of voting caps and restrictions in the articles on the transfer of shares.

⁷⁵ Report from the commission to the European parliament, the council, the European economic and social committee and the committee of the regions Brussels, 28.6.2012 COM(2012) 347 final. at p8.

⁷⁶ Ibid 24 at p575 "companies having acquisition plans will most probably opt into Article 9" and/or 11 of the DTB".

it hardly surprising that there has been a complete lack of company level decision making.⁷⁷ However, the fact that Italian companies have opted out of the BNR provides evidence that company level decision making can be a viable course of action so long as the right defaults are chosen. Indeed, it has been suggested that the most efficient takeover reforms would revolve around a form of horizontal subsidiarity.⁷⁸ A bright-line approach to a mandatory BNR implemented at the Member State level provides a heavy-handed approach which inevitably results in inefficiencies. Individual takeovers and companies' exposure thereto are efficient or inefficient depending on a variety of factors which change over time, from industry to industry and company to company.⁷⁹ Therefore placing the board neutrality decision at the company level may well be the best solution, so long as the mechanism is implemented in a way which counteracts the existing problems of agency costs, collective action and rational apathy. How such a mechanism could be crafted will be the topic of chapter 5 of this thesis.

3.5 Conclusion - did the Board Neutrality Rule achieve its aims?

It perhaps seems questionable then, whether the transposition of the BNR can be called a "relative success". If the aims of the BNR can be seen as facilitating bids and harmonising the rules, neither of these appear to have been achieved. In fact, being judged by these standards has led to no shortage of critics of the Directive. As far as harmonisation goes, it has been described as "hardly a triumph",⁸⁰ and "embarrassment for the EU as much time and effort was spent to achieve so little."⁸¹ This harsh criticism is based on the complex system of options and reciprocity which, as Mukwiri writes, creates the very barriers that the Directive aims to remove.⁸²

The aim of facilitating takeover bids fares no better. The most common outcome for Member States was to retain the status quo. Only five States became more bidder-friendly, while others used the transposition to slightly weaken a mandatory BNR by allowing for reciprocity. Moreover, Italy and Hungary abandoned a previously mandatory BNR in favour of an

⁷⁷ Ibid 1 at p147.

⁷⁸ Ibid 67 at p3.

⁷⁹ Ibid 67 at p3.

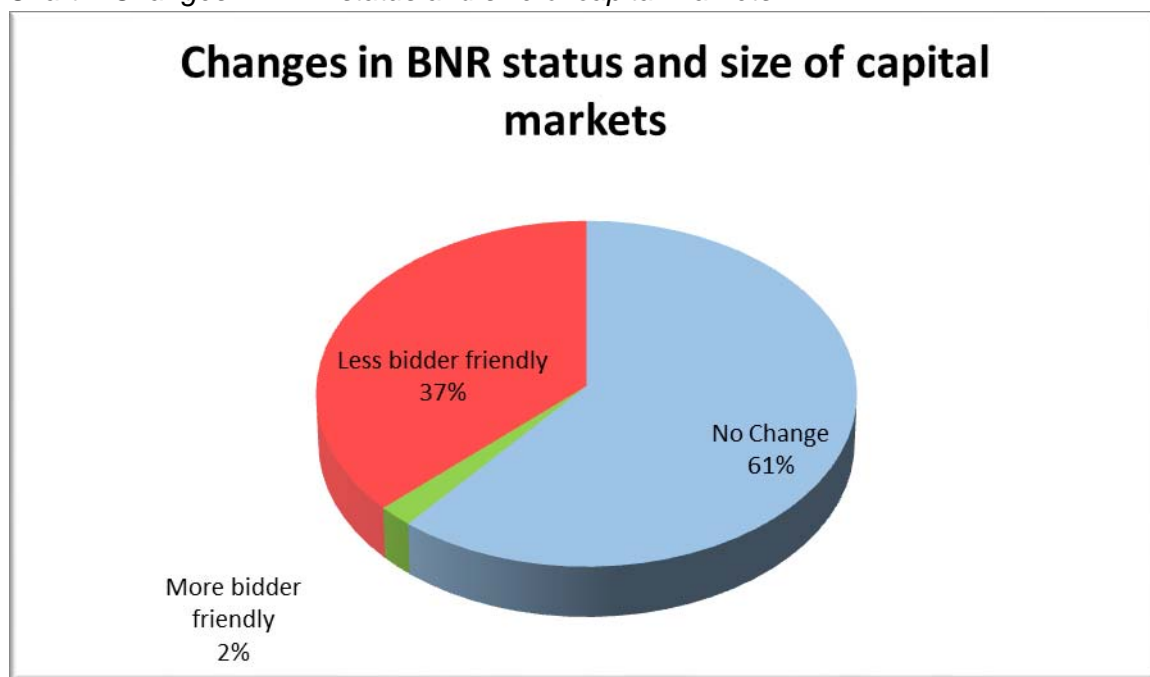
⁸⁰ P. Scott, *The Takeover Panel Report on the Year ended 31 March 2004* (London: The Takeover Panel, 2004), p.8.

⁸¹ E. Ferran, *Building EU Securities Market* (Cambridge: Cambridge University Press, 2004), p.117.

⁸² Jonathan Mukwiri, *Takeovers and the European Legal Framework: A British Perspective*, (Routledge 2009) at p7.

optional one, and in terms of economic impact they outweigh the five States which became more bidder friendly by a factor of three.⁸³ Had the Commission successfully passed the Directive they originally wanted, these actions would not have been permitted. Therefore, not only can it be concluded that the implementation of the BNR under the Directive did not achieve the aims the Commission wanted, if anything it represents a "major setback" by their standards.⁸⁴ Looking at the Community market capitalisation highlights this. The States which became less bidder-friendly represent a much higher percentage than those which increased bidder-friendliness, as shown by the following chart:

Chart1: Changes in BNR-status and size of capital markets



*Source: Davies et al*⁸⁵

The above paints a bleak picture of the implementation of Article 9, however the outcome is not necessarily as bad as it suggests. Harmonisation may have been an aim of the Commission, however it is submitted that harmonising takeover rules is not a desirable approach for Europe. Allowing companies in Member States with different varieties of capitalism to preserve their unique comparative advantages would promote a more competitive Europe.⁸⁶ The BNR evolved in the liberal market economy of the UK,⁸⁷ and harmonisation based around transplanting a mandatory form of this rule to the different

⁸³ Ibid 1 at p154.

⁸⁴ Ibid 1 at p153.

⁸⁵ See 'table 4' on p156 for dataset in Davies et al, above, footnote 1.

⁸⁶ A. Nilsen, *The EU takeover Directive and the competitiveness of European Industry*, The Oxford Council of Good Governance, at p3.

⁸⁷ C. Gerner-Beuerle, Kershaw, D., & Solinas, M, "Is the Board Neutrality Rule Trivial? Amnesia about Corporate Law in European Takeover Regulation", (2011) *LSE Law, Society and Economy Working Papers*, at p2.

coordinated market economies in continental Europe is not the best solution. As Sjäffjell writes;

"It seems somewhat paradoxical that, rather than first considering rationally the pros and cons of the existing systems of corporate governance in Continental Europe, the Commission tries through the Takeover Directive to facilitate simultaneously the introduction of the Anglo-American shareholding structure and the solution to the problems that this very system is perceived to entail."⁸⁸

Therefore, while the optional nature introduced by the implementation of the BNR may have failed to meet the Commission's aims, it has inadvertently laid the foundations for an efficient European takeover regime based on choice. The real failure of the Board Neutrality system under the Directive is placing that choice at the Member State level and thus failing to take into account company specific characteristics which differ across types of economies. Further, the reciprocity system was not based on a coherent economic rationale and represents a regression in terms of corporate law evolution. To conclude, there is a valid place for the BNR in European takeover regulation, however it is in need of reform to maximise the benefits it can provide. The next chapter will look at the BTR, which suffers from the same faults as the BNR, before chapter 5 builds on this analysis to consider how an efficient reform could look.

⁸⁸ B. Sjäffjell, 'Political path dependency in practice: The takeover directive', Nordic & European Company Law Working Paper No. 10-09. Available at SSRN: <http://ssrn.com/abstract=959999> at p7.

Chapter 4 – The Breakthrough Rule under Article 11

Introduction

The creation of a level playing field under the Takeover Bids Directive was driven by two guiding principles – shareholder decision making and proportionality between risk-bearing capital and control.¹ The first of these two principles is reflected in the BNR of Article 9 and the general principle of Article 3(1)(c).² The second principle is the proportionality principle. According to this, the greater the degree of risk bearing capital that the shareholder bears, the greater their degree of control over the company. Put differently, the greater the risk a shareholder is exposed to, the louder his voice should be in determining the manner of its control.³

Within the Directive, this principle is expressed by the BTR in Article 11.⁴ Certain capital and control mechanisms found throughout corporate structures grant disproportionate control rights compared to their level of share capital. These 'control enhancing mechanisms' (CEMs) can constitute a pre-bid takeover defence and allows for a minority shareholder to entrench themselves by retaining majority voting power, for example through the use of multiple-vote shares. The BTR allows for a bidder to 'break-through' such mechanisms once they have acquired a 75 percent threshold of voting capital.⁵ The effect of the BTR is to introduce a 'one share - one vote' principle during the takeover window, thus limiting both the power and use of pre-bid defences. Doing so opens up the market for corporate control, both allowing for the disciplining effect of takeovers and facilitating their corporate restructuring benefits. The High Level Group envisioned the BTR to work in tandem with the BNR to simultaneously prevent pre and post bid defences, since prevention of only one type would incentivise the use and prevalence of the other.⁶

¹ High Level Group of Company Law Experts, *Report on Issues Related to Takeover Bids*, Brussels 10 January 2002 at p2-3.

² Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids. Specifically it states, "the board of an offeree company must 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".

³ J. Rickford, 'The Emerging European Takeover Law from a British Perspective' (2004) EBLR 1379 at p1385.

⁴ T. Papadopoulos, "Legal Aspects of the Breakthrough Rule of the European Takeover Bid Directive". *takeover regulation: a legal approach*, Icfai Books, Icfai University Press (IUP), Icfai University, 2008.

⁵ Article 11(4), Takeover Bids Directive.

⁶ G. Ferrarini & Miller, G, "A Simple Theory of Takeover Regulation in the United States and Europe", (2010) *ECGI Law Working Paper* (139).

Much like the BNR however, in order to reach a political compromise the BTR had to be made optional for Member States.⁷ Unlike the BNR however, implementation of the BTR by the Member States is extremely low level, with only Latvia, Lithuania and Estonia implementing the rule.⁸ Moreover, it is generally accepted that the current rule as set out by Article 11 suffers from multiple deficiencies, arguably caused by political opportunism at the compromise stage.⁹ The structure of this chapter shall be as follows. Firstly it will consider the characteristics of the BTR and how it operates, before going on to give an overview of its implementation in the Member States (or lack thereof). It will then critically evaluate whether it is deficient, before finally looking at the use of CEMs in Europe and Concluding.

4.1 Operation of the Breakthrough Rule

Using control enhancing mechanisms (CEMs) allows a minority shareholder to maintain himself as a controlling blockholder by dissociating capital and control. Thus, takeovers which the majority of the shareholders would be in favour of can be frustrated by the minority controller. However, the BTR operates to temporarily, during the takeover window, transform a target company with a controlling minority shareholder into a company with dispersed ownership for the purpose of facilitating takeover bids.¹⁰ In essence, it applies a limited 'one share -- one vote rule' during the acceptance period of a bid, and at the first general meeting of shareholders called by the offeror (provided the offeror was successful in acquiring 75 percent of the capital carrying voting rights).

Specifically, once a bid has been made public¹¹ Article 11(2) states that any restrictions on the transfer of securities, provided for in;

- i. the articles of associations of the offeree company, or
 - ii. contractual agreements between the offeree company and the holders of its securities, or
 - iii. contractual agreements between the holders of the offeree company's securities
- shall not apply vis-à-vis the offeror during the time allowed for the acceptance of the bid.

Once a bid has been made public, Article 11(3) states that voting restrictions provided for in;

⁷ C. Clottens & Geens, K "One Share – One Vote: Fairness, Efficiency and (the Case for) EU Harmonisation Revisited" (2010) at p21. Available at <http://ssrn.com/abstract=1547842>.

⁸ Commission Staff Working Document. Report on the Implementation of the Directive on Takeover Bids, 21 February 2007, SEC(2007) 268.

⁹ Ibid 4 at p10.

¹⁰ Ibid 7 at p19.

¹¹ Article 11(1) Takeover Bids Directive.

i. the articles of associations of the offeree company, or

ii. contractual agreements between the offeree company and the holders of its securities, or

iii. contractual agreements between the holders of the offeree company's securities,

shall not have effect at the general meeting of shareholders which decides on any defensive measures in accordance with Article 9. In addition, Article 12(3) explicitly states that multiple-vote securities will only carry only one vote each at the general meeting of shareholders deciding on defensive measures in accordance with Article 9.

Article 12(2) and (3) only apply to contractual agreements entered into after the adoption of the Directive.

Article 11(4) provides that, where following a bid, the offeror holds at least 75 percent of the capital carrying voting rights, none of the above restrictions referred to in 11(2) and (3) and none of the "extraordinary rights" of shareholders in the articles of association concerning the appointment or removal of board members shall apply. Furthermore, multiple-vote securities will carry one vote each at the first general meeting of shareholders following closure of the bid, called by the offeror to amend the articles or appoint or remove directors.¹² To this end, Article 11(4) further allows the offeror to call a general meeting at short notice, provided it does not take place within two weeks of notification.

Article 11(5) states that where rights are removed on the basis of paragraphs (2), (3) or (4) then equitable compensation is to be paid to the holders of those rights. However the Directive leaves the terms for quantification and delivery to the Member States, which it will be argued below results in a significant deficiency of the BTR.

Articles 11(6) and (7) provide exceptions to the application of Article 11(3) and (4) if the restriction on voting rights is compensated for by "specific pecuniary advantages" (Paragraph (6)) or if the rights are held as 'golden share' by Member States (Paragraph (7)).¹³ There is a danger that the 'specific pecuniary advantage' exception could be exploited by companies as a means of evading the application of the BTR, which will be discussed below as one of the deficiencies.

¹² B. Clarke "Articles 9 and 11 of the Takeover Directive (2004/25) and the Market for Corporate Control" [2006] *Journal of Business Law* at p367.

¹³ See Article 11(7), "Where Member States hold securities in the offeree company which confer special rights on the Member States which are compatible with the treaty, or to special rights provided for in national law which are compatible with the Treaty or to cooperatives".

Optionality

As with the BNR, the BTR is rendered optional at the Member State level by Article 12 of the Directive. Despite the BTR being seen as a 'cornerstone' of the Directive by the Commission¹⁴, the Directive itself owes its existence to political compromise, thus the optionality of the BTR (and BNR) was a political necessity.¹⁵

Article 12 (1) provides that "Member States may reserve the right not to require companies... to apply Article 9(2) and (3) and/or Article 11." This creates a choice at the Member State level allowing for the State in question not to apply BTR (and/or BNR). The Directive further requires that where a Member State employs the opt-out provision, they must provide a reversible option for companies to opt 'back in'. This company-level decision is to be taken by the shareholders in accordance with the rules applicable in that jurisdiction for adopting changes to the companies' articles of association.¹⁶

As discussed with regards to the BNR in the previous chapter, although the Member States are free to choose whether or not to apply the BTR, the language used to express the option clearly shows that opting-out was not the desired outcome envisioned by the drafters.¹⁷ It was hoped by the Commission that Member States would choose to apply the BTR. Moreover, the transparency requirements in Article 10 of the Directive are "implicitly based on the 'one share - one vote' system, insofar as deviations from this line ought to be disclosed."¹⁸ 'One share - one vote' is therefore the background model for disclosure requirements, and thus appears to be an implicit endorsement by the EU legislator of 'one share - one vote' being an aspirational, if not legal, principle.¹⁹ The Commission hoped that market pressures would provide incentives for Member States to adopt the BTR.²⁰ Such pressures could come in the form of institutional investors who welcome adherence to a 'one

¹⁴ Ibid 1

¹⁵ Ibid 4 at p4.

¹⁶ Takeover Bids Directive, Article 12(2).

¹⁷ P. Davies, Edmund-Philipp Schuster, & Emilie van de Walle de Ghelcke, *The Takeover Directive as a Protectionist Tool?* in *Company law and economic protectionism: New challenges to European Integration* (Ulf Bernitz & Wolf-Georg Ringe eds. 2010) at p21.

¹⁸ H. Hirte, 'The Takeover Directive - a mini-Directive on the structure of the Corporation: Is it a Trojan Horse?' (2004) ECFR 1 at p10.

¹⁹ G. Ferrarini, 'One Share - one vote: A European Rule?' (2006) EGCI Working Paper Series n58/2006 at p17.

²⁰ Ibid 1. See also B. Clarke "Articles 9 and 11 of the Takeover Directive (2004/25) and the Market for Corporate Control" [2006] *Journal of Business Law* at p372.

share - one vote' standard.²¹ Neither was the Commission's hope far-fetched - a sharp decrease in the use of some pre-bid defences observed in US firms was attributed to pressure from institutional investors in a 2010 study.²²

In summary, the optionality clause in Article 12 allows Member States to choose not to require companies to apply the BTR, whilst allowing companies the opportunity to 'opt back in' should they so choose.

Reciprocity

Article 12 further introduces the novel concept of reciprocity. Under Article 12(3) Member States are allowed to let companies subject to the BTR, refrain from applying those rules if the bidder is themselves not subject to them.

As with the optionality clause, reciprocity creates choices at both the Member State and Company levels. If a Member States chooses to allow Companies to use the reciprocity exception, then the company can authorise through its shareholders at a general meeting an exemption from the BTR if the bidder does not himself apply the BTR. Such authorisation must be made no earlier than 18 months before the bid is made public by the offeror company.²³

Reciprocity for the BTR acts in the same way as for the BNR and a brief account of its history and criticisms has been discussed in the previous chapter, reaching the same conclusions as the ECLE (European Company Law Experts), that reciprocity is both 'flawed' and 'superfluous'.²⁴ The next chapter will consider in greater depth whether reciprocity should be a characteristic of the Takeover Directive however it is now time to turn attention to the transposition (or rather lack of) of the BTR.

²¹ Ibid 19 at p5. See also, Shearman & Sterling, Institutional Shareholding Services, & European Corporate Governance Institute. (2006), *Report on the Proportionality Principle in the European Union*, European Commission, Section 5.3 'Comments on the Survey'.

²² A sharp decrease in the use of Poison Pills and Staggered Boards was observed. See Hill, J. G. (2010), "Takeovers, Poison Pills and Protectionism in Comparative Corporate Governance", *ECGI Law Working Paper*, 168 (November).

²³ Takeover Bids Directive, Article 12(5).

²⁴ See Chapter 3 of this Thesis, 'Reciprocity' Section. Also, Response to the European Commission's Report on the Application of the Takeover Bids Directive (November 30, 2013). University of Cambridge Faculty of Law Research Paper No. 5/2014.

4.2 Transposition of the Breakthrough Rule

Transposition of the BTR has been extremely low level by the Member States. Only Estonia, Latvia and Lithuania have transposed the rule. With regards to reciprocity, none of the States allow for it.²⁵

Although only three Member States have opted for a mandatory BTR, it should be recalled that the Directive allows for a company-level opt-in where the rule is not mandatory.²⁶ However, to date there has not been a single reported case of a company opting-in to the BTR on a voluntary basis.²⁷ This can be attributed to two factors. Firstly the substantive text of the BTR as it appears in the Directive is deficient, as will be demonstrated below, thus voluntary application remains an unattractive option.

Secondly and more importantly, the BTR is designed to remove pre-bid defences which confer disproportionate voting rights. Opting-in is achieved at the shareholders meeting, essentially requiring the approval of those that it is detrimental to.²⁸ It seems exceptionally unlikely that a controlling blockholder would voluntarily weaken their position by opening themselves to hostile bids. The only feasible rationale for a controlling shareholder to do so would be if the company had acquisition plans, thus opting-in to prevent potential targets from using the reciprocity exception against them.²⁹ This incentive however is reliant on other companies subject to the BTR applying the reciprocity exception. Since the 3 Member States which have a mandatory BTR do not allow for reciprocity, and not a single listed company in any other Member State has voluntarily applied the BTR, this incentive is currently reduced to zero.

The following table details the implementation status of the BTR under the Directive, along with the Market capitalisations of listed companies. It is worth noting that the 3 Member States mandating the BTR have some of the lowest market capitalisations within the EU. The total market capitalisation of EU Member States was \$10,340,828 Million USD in 2012, and the combined market capitalisation of the 3 Member States applying the BTR was \$7,411million USD, or 0.071% of the total.³⁰ It can therefore be concluded that the implementation of the BTR in its current form has an extremely minor impact on European companies.

²⁵ Commission Staff Working Document. Report on the Implementation of the Directive on Takeover Bids, 21 February 2007, SEC(2007) 268, annex 1.

²⁶ Article 12(2) Takeover Bids Directive.

²⁷ Ibid 24, ECLE Response at p13.

²⁸ Ibid 25 at p8. (2007 Com report).

²⁹ M. Siems, 'The Rules on Conflict of Laws in the European Takeover Directive'. (2004) *ECFR* 1 at p460, footnote 8.

³⁰ Data used in calculations taken from *The World Bank Group*, available at <http://www.worldbank.org>.

Table 1: Breakthrough Rule Implementation

Country	Breakthrough Rule	2012 Market Capitalisation (Million USD)
UK	No	\$3,019,467
France	No	\$1,823,339
Germany	No	\$1,486,315
Spain	No	\$995,095
Netherlands	No	\$651,004
Sweden	No	\$560,526
Italy	No	\$480,453
Belgium	No	\$300,058
Denmark	No	\$224,856
Poland	No	\$177,730
Finland	No	\$158,687
Ireland	No	\$109,014
Austria	No	\$106,037
Luxembourg	No	\$70,339
Portugal	No	\$65,530
Greece	No	\$44,584
Hungary	No	\$21,080
Romania	No	\$15,925
Bulgaria	No	\$6,666
Slovenia	No	\$6,475
Slovak Republic	No	\$4,611
Lithuania	Yes	\$3,964
Malta	No	\$3,631
Estonia	Yes	\$2,332
Cyprus	No	\$1,996
Latvia	Yes	\$1,115

Source: Author. Data Source: World Bank Group. Market Capitalisation figures from year 2012.

As mentioned above, there are a number of deficiencies with the substantive text of the BTR. The next section will critically assess these and attempt to explain why the implementation of the BTR has been so low.

4.3 Deficiencies of the Breakthrough Rule

It has been argued that the BTR is deficient in two respects: with regards to the substance of the rule and the fact that it has been rendered optional by Article 12.³¹ As a culmination of these deficiencies the BTR has failed to meet the objectives of the Commission and has not facilitated takeover activity across Europe. Firstly, the substantive problems of the BTR will be assessed.

Restrictions on transfer of shares

Article 11(2) prohibits restrictions on the transfer of shares. When these restrictions are provided for in contracts between shareholders the prohibition is perhaps too wide. Papadopoulos points out that such restrictions risk catching normal market arrangements,³² such as pre-emption rights and option rights, sale agreements with deferred settlement, and irrevocable undertakings to accept a takeover offer (which usually involve a restriction on sale of the shares concerned to a 3rd party).³³ These are sophisticated financial instruments that are often pro or at least neutral to takeover activity and prohibiting them would have a negative impact on facilitating takeovers. Not only this, but such deficiencies can be seen as direct contributors to the failure to implement the BTR - at the time there was a significant lobby group in the UK pushing for the government to opt-out of the BTR so irrevocable undertakings would not be prohibited.³⁴ Thus, a blanket prohibition on restrictions on transfers goes too far. The Directive would be more effective and more popular with market actors if specific exemptions were allowed for financial structures which are takeover friendly, or at least neutral.³⁵

Ceiling Shares

³¹ J. Rickford, 'The Emerging European Takeover Law From a British Perspective' (2004) EBLR at 1389-90

³² Ibid 4 at p4.

³³ V. Edwards 'The Directive on takeover bids - not worth the paper its written on?' (2004) 4 ECFR 416 at p437.

³⁴ Ibid.

³⁵ Ibid 4 at p5.

While it was argued above that the restrictions on transfers of shares is too wide, when it comes to categories of securities caught by the BTR, the scope is too narrow. Any category of securities outside the scope of the BTR are therefore not 'broken-through' and remain as an obstacle to potential bidders.

The first problem is created by the text of the Directive.³⁶ Article 2(1)(g) defines multiple-voting securities as "securities included in a distinct and separate class and carrying more than one vote each." The issue here is that 'ceiling' or 'time-lapse' shares, commonly used in France, are not caught by the BTR. These shares are only fully enfranchised after a specific period of time, which can be up to four years.³⁷ From a defensive standpoint, these would require a bidder to wait a significant amount of time before their control rights are realised, thus making them an effective tool in discouraging acquisition. Even though their voting rights vary from time to time, according to the contingency of the duration of a holding, they remain of the same class and are therefore not caught by the BTR.³⁸

Non-voting shares

Another category which evades the application of the BTR is that of non-voting shares.³⁹ Under the proportionality principle, non-voting equity is clearly a violation and thus non-voting shares should be appropriately enfranchised to carry their proper weight respective to their equity in the company. However, the strict definition provided for in Article 2(1)(e) is problematic as it defines as securities only those carrying 'voting rights in a company'. Thus, non-voting shares are not caught by the BTR and will not be enfranchised in the hands of an offeror in a post-breakthrough meeting, nor will they provide a vote to holders at a meeting to decide on defensive measures. This leads J. Rickford to conclude, "a company which renders itself bid-proof by keeping voting shares in the hands of the board and its supporters and issuing non-voting equity to others is not vulnerable to break-through on that account".⁴⁰

To use a basic example;

Company X has 10 'A' shares and 90 'B' shares. 'A' Shares carry votes while 'B' Shares are non-voting. Even if a party acquires all the 'B' shares, assuming 90% of the cash-flow rights, they will be unable to apply the BTR and the company will remain in the control of whoever

³⁶ Ibid 4 at p6.

³⁷ J. Rickford 'Takeovers in Europe - shareholders decisions and open markets - a UK Perspective' in J. Grant (ed), *European Takeovers: the Art of Acquisition* (1st ed Euromoney Books) 2005 at p67.

³⁸ Ibid 4 at p7.

³⁹ Ibid 4 at p8.

⁴⁰ Ibid 31 at p1392.

owns the 'A' shares. Clearly then, non-voting shares are a considerable obstacle to contestability of control, which the BTR fails to remove.

Non-voting shares are prohibited in certain countries, however this inevitably leads to regulatory arbitrage where alternatives with the same effect are sought.⁴¹ One such alternative technique which has the same economic result as non-voting shares is to utilise non-voting depository receipts or certificates for shares. Under these financial instruments, voting rights are separated from their shares and transferred to an administrator.⁴² The shareholder retains the propriety rights, but the voting power lies with the administrator, thus dissociating capital and control. There is no provision in the BTR that voting power reverts back to the shareholder in a takeover situation, thus contravening the proportionality principle. As a result, even in member States which prohibit non-voting shares, alternative mechanisms exist to circumvent the BTR.⁴³

Pyramids and Cross-shareholdings

Crucially, the BTR does not deal with two of the most effective pre-bid defence mechanisms for dissociating capital and control, namely pyramidal groups and cross-shareholdings, which are factual structures as opposed to legal structures.⁴⁴ Pyramidal groups are a structure whereby a company holds shares in another company which in turn holds shares in another, creating a chain of interposed entities.⁴⁵ Control of the company at the top of the chain allows for outright control of the entire chain (or pyramid). Control of the top of the pyramid requires a lower amount of capital than would otherwise be needed to control the rest of the companies in the chain. Essentially this fulfils the same economic objective as multiple-vote securities: allowing a blockholder to enhance control by leveraging more voting power than is proportionate to their ownership share.⁴⁶

Cross-shareholdings are another form of pre-bid defence that the BTR does not apply to. Two companies buy stakes in each other with senior management and/or owners sitting on

⁴¹ J. Maeijer and K. Geens (eds), *Defensive measures against hostile takeovers in the Common Market* (Martinus Nijhoff publishers and Graham and Trotman, London 1990) at p19-20.

⁴² Marccus Partners, *The Takeover Bids Directive Assessment Report*, p309 available at http://ec.europa.eu/internal_market/company/takeoverbids/index_en.htm

⁴³ Papadopoulos also notes that 'enjoyment rights' common in Germany are another mechanism which acts as an alternative to non-voting shares. See nr4 above, at p10.

⁴⁴ Ibid

⁴⁵ J. Grant, 'Takeovers and the market for corporate control' in *European Takeovers: the Art of Acquisition* (1st ed Euromoney Books) 2005 at p15.

⁴⁶ Ibid 42.

each other's boards to vote their shares defensively.⁴⁷ The BTR does not affect these corporate links, but they remain as device to frustrate takeovers by requiring that a bidder must acquire both companies in a takeover attempt.

These two control enhancing mechanisms lie outside the scope of the BTR, which is problematic for two reasons. Firstly, existing pyramids and cross-shareholdings clearly represent a barrier to facilitating takeover bids. Secondly and more importantly however, even if a hypothetically effective and mandatory BTR was applied across the Member States, controlling blockholders wishing to keep the same disproportionate voting structure could simply reorganise their corporate structures into a pyramid structure.⁴⁸ This theory is supported by the example of Belgium, where in 1934 a strict 'one share - one vote' law was applied, leading to a sharp increase in the emergence of pyramids.⁴⁹ Thus, if the current formulation of the BTR were mandatory it would still leave blockholders that rely on multiple-vote shares an opportunity to maintain the status quo by reorganising to a pyramid structure. It is therefore submitted that in order for any reform of the BTR to be effective, simultaneous reforms that deal with pyramids would need to be considered. This topic is further discussed in the next chapter which focuses on reform of the BNR and BTR.

Equitable compensation for 'broken-through' rights

The Directive provides for equitable compensation for loss suffered by shareholders whose rights are 'broken through'.⁵⁰ Crucially however the directive states that "the terms for determining such compensation and the arrangements for its payment shall be set by Member States."⁵¹ When it comes to applying this provision in practice, difficulties arise given that no method of quantification, method of delivery or which party pays is considered. In short, the Directive does not address 'how, when or who' pays.⁵²

Leaving this process to the Member States creates the possibility of inequalities. Shareholders may receive different levels of compensation for broken through shares of equal value in similar takeover cases based on the particular State's adopted method of quantification.⁵³ Moreover, this inequality may apply to shares of the same company when

⁴⁷ Ibid 4 at p 11.

⁴⁸ Ibid 42 at p196.

⁴⁹ M. Becht et al., "Shareholding Cascades: The Separation of Ownership and Control in Belgium", in F. Barca and M. Becht (eds.), *The Control of Corporate Europe*, Oxford University Press, 2001, 71-105.

⁵⁰ Article 11(5) Takeover Bids Directive.

⁵¹ Ibid

⁵² Ibid 4 at p18.

⁵³ Ibid 4 at p18.

they are listed on different stock exchanges. Such an outcome cannot be said to be in line with the level playing field that the Commission envisaged.⁵⁴

Appraisal procedures to quantify compensation may also cause problems with regards to the timing of the bid.⁵⁵ This is especially true if Member States decide to allow some form of mechanism for appeals and adjudication. Papadopoulos considers that any delays in the quantification process exacerbate the pressure-to-tender problem if the process takes place before or during the public offer period. Companies' shares are of course listed on stock markets and therefore subject to price fluctuations. A pending quantification process may have a detrimental effect on the price of the shares of the listed company.⁵⁶

Conclusions on the shortcomings of the breakthrough rule

It has been established that there a number of deficiencies with the BTR as it is currently formulated. The optional nature of the BTR has led the vast majority of Member States to maintain the status quo by choosing not to implement the rule. This result is hardly surprising given its 'unbalanced' and 'incomplete' nature which is compounded by the uncertainty caused by the issue of compensation.⁵⁷

Due to the lack of implementation of the BTR, it can be said that it failed to achieve the objectives set out by the Commission - to neutralise pre-bid defences, create a level-playing field and facilitate takeover activity. However, even if application of the BTR had been mandatory, in its current formulation it could still be considered a failure.

The BTR was intended to prohibit legal structures which constitute pre-bid defences (as opposed to factual structures such as pyramids). However, there are so many exemptions to the BTR that Geens and Clottens conclude that "multiple voting rights shares seem to be one of the few CEMs actually covered, *if not the only one*."⁵⁸ It seems that companies can relatively easily evade the application of the BTR by utilising:

i. Non-voting shares

⁵⁴ S. M. Bartman, 'Analysis and consequences of the EC Directive on takeover bids' (2004) 1 ECL 5, at p8.

⁵⁵ Ibid 37 at p72.

⁵⁶ Ibid 4 at p 20.

⁵⁷ Ibid 7 at p21.

⁵⁸ Ibid 7 at p21. Emphasis added.

- ii. Depository receipts or certificates for shares in countries which prohibit non-voting shares
- iii. Ceiling / Time-lapse shares
- iv. Preference shares⁵⁹
- v. Pyramidal Groups / Cross shareholdings

It has been argued that this wide range of exceptions is a result of political opportunism at the negotiating stage of the Directive, where certain Member States were able to effectively exempt structures commonly used in their jurisdiction, such as France with ceiling shares.⁶⁰ As a result, a mandatory application of the BTR across Europe would produce very uneven results - largely affecting Scandinavian countries where multiple-voting shares are particularly common, but leaving CEMs in other Member States largely intact. From an economic standpoint, it is difficult to justify the selective application of the 'one share – one vote' principle only to a selection of CEMs.⁶¹ This leads J. Coates to conclude that the present BTR would not achieve a level playing field.⁶² Indeed the BTR was perceived by some as so unbalanced that it constituted an "attack on the Nordic voting model."⁶³

Use of CEMs in Europe

In 2006 the Commission undertook a study on the proportionality principle in listed companies within the EU.⁶⁴ This study revealed the widespread use of CEMs across Member States, as shown in the table below.

Table 1: Presence of CEMs in EU Member States

⁵⁹ Shares where the restrictions on voting are compensated for by 'specific pecuniary advantage', regardless of how small, and thus exempt from the BTR. See J. Rickford, Nr3 at p1392.

⁶⁰ Ibid 4 at p7-8.

⁶¹ Ibid 42 at p309.

⁶² J. Coates, "Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?", in G. Ferrarini, K. Hopt, J. Winter and E. Wymeersch (eds.), *Reforming Takeover and Company Law in Europe*, Oxford, Oxford University Press, 2004, 682

⁶³ U. Bernitz, "The Attack on the Nordic Voting Rights Model: The Legal Limits under EU Law", *EBLR* 2004, 1423-1437

⁶⁴ Shearman & Sterling, Institutional Shareholding Services, & European Corporate Governance Institute. (2006), *Report on the Proportionality Principle in the European Union*, European Commission

	Companies surveyed	At least one CEM	At least one CEM	Multiple voting rights	Non-voting shares	Non-voting preference shares	Pyramid Structures	Voting right ceilings	Ownership ceilings	Golden shares	Cross-shareholdings	Shareholders agreements	Total CEMs present	Total CEMs possible	Overall CEM Prevalence
Belgium	32	16	50%	0	0	0	11	0	0	1	0	10	22	288	8%
Denmark	23	8	34%	5	0	0	0	2	1	0	0	0	8	207	4%
Estonia	14	2	16%	0	0	0	2	0	0	1	0	0	3	126	2%
Finland	25	10	40%	8	0	0	0	2	0	0	0	1	11	225	5%
France	40	29	72%	23	0	0	7	4	0	0	2	7	44	360	12%
Germany	40	9	23%	0	2	5	5	1	0	1	1	0	16	360	4%
Greece	31	16	51%	0	0	1	10	2	3	0	0	2	18	279	6%
Hungary	22	13	60%	1	0	1	7	4	0	6	0	1	20	198	10%
Ireland	23	9	39%	0	1	4	0	1	1	1	0	1	9	207	4%
Italy	39	23	59%	0	0	7	11	3	7	6	1	9	44	351	13%
Luxembourg	19	3	16%	0	0	1	6	0	1	1	0	0	9	171	5%
Netherlands	23	15	65%	10	0	0	3	0	0	0	2	1	16	207	8%
Poland	40	17	43%	10	0	0	2	5	0	5	0	0	22	360	6%
Spain	24	15	62%	0	0	0	4	7	1	3	0	3	18	216	8%
Sweden	29	19	65%	17	0	0	14	1	1	0	5	2	40	261	15%
UK	40	12	31%	1	0	12	1	2	2	0	0	1	20	360	6%

Source: Adapted Marccus Partners, nr43 above

This data clearly indicates that the use of CEMs is not uncommon, and the BTR could potentially have a considerable effect on the market for corporate control and facilitating takeovers. Moreover in a study⁶⁵ looking at more than 1,000 European companies with dual-class shares, Bennedsen and Nielsen found 3% to 5% of companies where controlling owners held more than 50% of voting rights but less than 25% of the shares. Put differently, these firms would be subject to a direct loss of control in the face of the BTR.

A further 11-17% of firms were controlled by less than 50% voting rights and less than 25% of the shares, making them subject to a potential loss of control under the BTR. In total, the study shows that up to 22% of the firms surveyed would be affected by the BTR.

⁶⁵ M. Bennedsen, & K. Nielsen. (2004), "The Impact of a Break-Through Rule on European Firms", *European Journal of Law and Economics*, 17, 259-283.

4.4 Conclusion

The above data shows that the use of CEMs as a pre-bid defence is common across European firms and that a significant percentage would be affected by a mandatory BTR. However it is submitted that the current formulation of the BTR is deficient in a number of ways and reform would be needed before a new implementation is considered. The various shortcomings of the BTR can be summarised as:

- i. The reciprocity exception lacks sound economic justification,
- ii. The restrictions on the transfer of votes are too wide, catching pro- or neutral takeover financial instruments,
- iii. The BTR allows for numerous legal structure exceptions, such as ceiling shares and non-voting shares. This would result in a highly uneven application and an unlevel playing field,
- iv. The concept of compensation for 'broken-through' rights is vague and could result in unequal results,
- v. The BTR does not provide a solution for factual structures, such as pyramidal groups or cross-shareholdings, which allow for evasion of the BTR.

It is submitted that the greatest deficiency of the BTR is the final point - that factual structures, particularly pyramidal groups, are not dealt with. The reason for this is simple. Even if faced with an efficient BTR, we can expect many firms with a controlling blockholder to reorganise their ownership structure to a pyramid structure in order to maintain the status quo. Pyramid structures remain a highly effective pre-bid defence and are prohibited in no European Countries. It is therefore concluded that a reform of the BTR would need to be solved simultaneously with legislation that considers pyramidal groups. The next chapter will consider the deficiencies that have been discussed and consider how meaningful reform could be shaped.

Chapter 5 – Reforming The Board Neutrality and Breakthrough Rules

Introduction

The Previous chapters have evaluated the economic effects of takeovers, the usage of takeover defences and how the Board Neutrality (BNR) and Breakthrough (BTR) rules operate within the EU under the current regime. This chapter shall weave these strands together, in order to propose a reform of the BNR and BTR which would enable the most efficient takeover regime.

The debate on takeover law has traditionally had two conflicting sides. On the one hand are those who advocate a pro-takeover regime where target boards are prohibited from frustrating bids, thereby leaving the ultimate decision of whether a takeover succeeds down to the shareholders. On the other hand, others believe management should be able to block a takeover when it is in the best interest of the company to do so. Thus, much of the debate has revolved around a simple question:¹ should management or shareholders decide on the success of a takeover bid?

The complexities of the issue and the existence of merits on both schools of thought reflect the dogged persistence of the debate² and resulted in the arduous and long-winded path to adoption of the Takeover Bids Directive. Even then, the Directive was only passed in a watered-down form, constituting a 'flexible-framework'³ approach where the two 'cornerstones',⁴ namely the BNR and BTR, were rendered optional by Article 12.

It will be demonstrated that the optionality element of the Directive was borne out of political compromise that necessitated the adoption of the Directive. Consequently, when the regime is observed from a legal-economic perspective, it does not appear to be the most efficient regime possible. This chapter shall identify what the characteristics of an efficient regime

¹ While this has traditionally been the central question of takeover law, such a simplification does not of course do justice to the many nuanced positions that have been adopted. See M. Becht, P. Bolton and A. Roell, 'Corporate law and Governance', in *Handbook of Law and Economics* (. A. Mitchell and Steven Shavell) eds 2007) at pp833-886.

² Luca Enriques, Ronald Gilson, Alessio Paces, 'The Case for an Unbiased Takeover Law (with an Application to the European Union)' (May 1, 2013) at p2. ECGI - Law Working Paper No. 212; Columbia Law and Economics Working Paper No. 450 at p1.

³ Wouters et Al. (2009) 'The European Takeover Directive: a commentary', in Hooghten P.V. (Ed.): *The European Takeover Directive and Its Implementation*, pp.3–76, Oxford University Press, New York.

⁴ Described as 'Cornerstones' by the Winter Group. High Level Group of Company Law Experts, *Report on Issues Related to Takeover Bids*, Brussels 10 January 2002.

entail with regards to takeover defences, before presenting a case for the reform of the BNR and BTR in-line with these characteristics.

5.1 The Characteristics of an Efficient Takeover Regime - A Neutral Approach

Defining an 'efficient' takeover

First of all it would be pertinent to set a definition of an 'efficient' takeover. For the purposes of this thesis and as was used in the economic analysis of the second chapter, efficiency will be measured in terms of gains or losses in shareholder value. The rise or fall in share price yields a useful evaluation criterion and is the norm in financial theory.⁵ Put differently, the 'success' of a takeover will be judged on whether the winner's gains exceed the loser's losses in terms of shareholder value.⁶ If the cumulative shareholder value of target and bidder is positive, then the particular takeover can be said to be value-increasing, i.e. efficient.

Using this criterion naturally does not account for the interests of other constituencies on which the takeover may have an effect (such as employees, local communities, customers, etc). This is not to say that such stakeholders are unimportant, but rather academic opinion suggests that takeover regulation is not the best available means of safeguarding these stakeholder's interests.⁷ As such, they are not factored in when deciding if a takeover is efficient for the purposes of this thesis.

Shareholder versus Director Primacy: A Summary

The traditional debate on takeover law has been whether management or shareholders should decide on tender offer. In this respect, two countries with the most vibrant and active takeover markets, the UK and the US, have strikingly different regulation of defensive mechanisms. In the UK, defences are essentially prohibited, leaving the decision to the

⁵ M Martynova & L Renneboog, 'A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?' (2008) 32 *Journal of Banking and Finance* 2148 at p2156.

⁶ This is known as the Kaldor-Hicks efficiency and states that a transaction is efficient if the winners could compensate the losers and still be better off. See John R Hicks, *The Foundations of Welfare Economics*, 49 *ECON J* 696 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, *ECON J* 549 (1939).

⁷ This view has been submitted by Enriques et al, see nr2 above, at p7-8.

shareholders, whereas Delaware jurisprudence in the US allows management to enjoy access to a range of defensive actions, albeit subject to an enhanced judicial standard.⁸

The debate between shareholder or management primacy persists due to the legitimate benefits that both regimes are purported to have by their advocates.⁹ The two positions were analysed in chapter 2 of this thesis and a brief summary is presented as follows.

Those who argue in favour of a takeover restrictive regime that allows management to raise takeover defences without shareholder approval cite a number of advantages. Firstly, it has been argued that implementing takeover defences discourages short-termism, allowing management to credibly commit to a long-term strategy and make specific investments in human capital.¹⁰ In this respect, hostile bids can represent a disruptive influence on well functioning companies.¹¹

Another frequent argument is that raising takeover defences allows the board to extract higher premia for the shareholders in the event of a takeover. Unlike shareholders, the board does not face collective action problems and can act as a central negotiator on behalf of the company.¹² By using the defences as a bargaining tool, management can force a bidder to revise and increase an offer, thereby generating greater shareholder value.¹³ It has been argued that the use of defences not only reinforces the Board's bargaining power in the case of a hostile takeover, but also in a friendly deal, where the target can counter the acquirer's implicit threat to 'go hostile' if a deal cannot be reached.¹⁴

The final argument supporting director primacy holds particular weight in light of the recent financial crisis. The 'efficient market hypothesis' states that the market participants act rationally and arbitrage eliminates pricing anomalies.¹⁵ Consequently, it posits share price is an accurate reflection of the intrinsic value of the company.¹⁶ However since reaching its

⁸ A. Seretakis, 'Hostile Takeovers and Defensive Mechanisms in the United Kingdom and the United States: A Case Against the United States Regime' (October 26, 2013). *The Ohio State Entrepreneurial Business Law Journal*, Vol. 8, No. 2, 2013.

⁹ Arguing in favour of shareholder primacy see e.g. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007). On the other hand, Stout and Blair put forward an articulate argument in favour of director primacy, Margaret M. Blair & Lynn A. Stout, 'Specific Investment: Explaining Anomalies in Corporate Law' (2006) 31 J. CORP. L. 719.

¹⁰ *Ibid* 2 at p3.

¹¹ M. Lipton, *Corporate Governance in the Age of Financial Corporatism*, 136 U. Pa. L. REV. 1 (1987) 18-20

¹² *Ibid* 8 at p274.

¹³ R. Comment, Schwert, G.W. "Poison or placebo? Evidence on the deterrence and wealth effects of modern antitakeover measures". *Journal of Financial Economics* 39 (1995) 3-43.

¹⁴ M. Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, (2002) 55 STAN. L. REV. 819, 823

¹⁵ Fama, EF "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25 *Journal of Finance* 383.

¹⁶ Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, (2002) 27 DEL. J. CORP. L. 1, 1 at p7.

apogee in the 1980s, this theory received widespread¹⁷ criticism and it is now widely accepted that markets do act irrationally and shares can be mispriced. Ergo, while a bid above the market value of the shares may appear beneficial for shareholders, it may in fact be coercive in nature as it is lower than the 'intrinsic value' of the firm.¹⁸ The argument states that management, who are better placed to understand the true value of the firm, should be armed with the ability to defend against such takeover bids which are undervalued.

In summary, the arguments in favour of director primacy allow for management to commit to long-term strategy, generate higher bid premia and protect the firm from undervalued bids.

On the other hand, shareholder primacy is widely accepted to have two significant benefits.¹⁹ Firstly it works as an external corporate governance mechanism to discipline underperforming managers. Theory suggests that dispersed shareholders face rational apathy and collective action problems and therefore lack the means to discipline an underperforming management. As such, the High Level Group in its 2002 report concluded that "actual and potential takeover bids are an important means to discipline the management of listed companies with dispersed ownership... Such discipline of management... is in the long term in the best interests of all stakeholders and society at large."²⁰ As a shareholder primacy regime requires shareholder consent for defences, this further prevents cases of takeover defences being used as a managerial entrenchment device, alleviating the conflict of interest that the board often faces during a hostile bid.

The second advantage of a pro-takeover regime is that it allows for wealth-creating takeovers to occur through synergistic gains. Here, contestability of corporate control serves a more general efficiency purpose.²¹ In some scenarios, the target's assets will be of unique value to the acquirer, allowing them to create value through synergy gains of the combined assets,²² which even the most talented managers of the target by themselves would not be able to achieve.

¹⁷ A. White, Reassessing the Rationales for the Takeover Bids Directive's Board Neutrality Rule (2012). *European Business Law Review*, Vol. 5, No. 23, 2012 at 793.

¹⁸ *Ibid* 8 at p275.

¹⁹ These are the benefits identified by the Winter group in its 2002 report. See, High Level Group of Company Law Experts, *Report on Issues Related to Takeover Bids*, Brussels 10 January 2002.

²⁰ *Ibid* at p19.

²¹ P. Davies, Edmund-Philipp Schuster, & Emilie van de Walle de Ghelcke, The Takeover Directive as a Protectionist Tool? in *Company law and economic protectionism: New challenges to European Integration* (Ulf Bernitz & Wolf-Georg Ringe eds. 2010) at p13.

²² R Romano, 'A Guide to Takeovers: Theory, Evidence, and Regulation' (1992) 9 *Yale Journal of Regulation* 119, 125-129.

The advantages of the two regimes have been laid out above. On the one hand, it is argued that takeover defences can allow management to secure higher premia, block undervalued bids and discourage short-termist approaches. On the other hand, prohibiting defences opens up the market for corporate control, allowing for underperforming management to be disciplined and also enabling wealth-creation through synergistic gains from bidder and target combined. It is widely accepted that both regimes have their merits, as is clear from the persistent and ongoing debate. The empirical economic evidence analysed in the second chapter drew a number of conclusions on these merits and these will now be used to help shape a more efficient regime than either a categorical pro or anti-takeover approach.

The Economic Evidence: Grounds for a Neutral Approach

The economic evidence analysed in chapter 2 drew a number of conclusions. Firstly, it is submitted that much of the academic literature attaches too much weight to the 'disciplining effect' of hostile takeovers. The empirical evidence shows that poor performance variables contribute little to nothing in determining whether or not a company would be the target of a hostile bid.²³ Put differently, managerial underperformance does not appear to be a motive for acquirers. Nevertheless it would be wrong to dismiss the theory outright. Since the data only applies to *actual* (observable) bids, the disciplining effect may still play an *ex ante* role on incumbent managers, as the threat of replacement if perceived to be underperforming provides an incentive to operate the company efficiently.²⁴ It is still capable of acting as a disciplinary force, but perhaps on a less comprehensive scale than is often purported.²⁵

Secondly are the conclusions drawn about the wealth effects of takeovers and defences. It was concluded that the aggregate wealth-effects of hostile takeovers are positive for targets and bidders combined, in both the short and long-term.²⁶ It is worth noting however, that this is largely due to the significant premium that target shareholders receive, with bidder gains being largely indistinguishable from zero.²⁷ On the question of takeover defences, the empirical studies surveyed show that on average, their adoption has a negative impact on

²³ For a study of US companies see, G. Schwert, . "Hostility in takeovers: in the eyes of the beholder?" *Journal of Finance* (2000) 55, 2599–2640; For the same result based on a study of UK companies, see J. Franks, Mayer, C. "Hostile takeovers and the correction of managerial failure". *Journal of Financial Economics* (1996) 40, 163-181.

²⁴ G. Tsagas, *EU Takeover Regulation: One Size Can't Fit All* (November 1, 2010). *International Journal of Private Law*, Vol. 4, No. 1, pp.171–184, January 2011 at p178.

²⁵ B Clarke, 'Reinforcing the Market for Corporate Control' (2010) *UCD Working Papers in Law, Criminology and Socio-Legal Studies*, Research Paper 39/2010 at p2.

²⁶ See Chapter 2 of this thesis for a survey of a number of studies, sections entitled, 'Short-term wealth effects of hostile takeovers' and 'long-term wealth-effects of hostile takeovers'.

²⁷ *Ibid.*

firm value.²⁸ It appears the market perceives takeover defences as managerial entrenchment devices rather than a collective bargaining tool.²⁹ However, while the aggregate result of adopting takeover defences is a decline in firm value, studies have shown that in particular circumstances they are legitimately used by the board for the benefit of the shareholders.³⁰

Based on the above conclusions, it can be said that the economic evidence counsels in favour of choosing a 'pro-takeover' regime, that assigns the decision making right to shareholders and overall facilitates takeover activity.³¹ Since takeovers are wealth creating in the aggregate, and takeover defences have a negative impact, in a categorical 'pro versus anti-takeover debate' prohibiting defences would be the better option. The central problem here is that it leads to inefficiencies where companies are locked into a regime that prohibits them from raising defences which would be beneficial under certain circumstances.³²

The most desirable regime of all would require that firms adhere to 'pro-takeover' rules for the most part, but allows for deviation from this when it is efficient to do so. Thus, the 'pro versus anti' debate represents a false dichotomy and instead a neutral approach would be a positive advancement for European takeover regulation. While the Winter Group concluded that;

*"any regime which confers discretion on a board to impede or facilitate a bid inevitably involves unacceptable cost and risk"*³³

it is respectfully submitted that this is not the case. A blanket prohibition on the board to implement defences creates inefficiencies unnecessarily. Moreover, a study by Arcot and

²⁸ Marco Becht, Patrick Bolton, & Ailsa Röell, *Corporate Law and Governance*, in Handbook of law and Economics, p879 (A. Mitchell Polinsky and Steven Shavell eds., 2007); and P. Gompers, Ishii, and Metrick, 'Corporate Governance and Equity Prices' Quarterly Journal of Economics, Vol. 118, No. 1, pp. 107-155, (2003).

²⁹ G. Jarrell, Poulsen, . (1987). "Shark repellents and stock prices: the effects of antitakeover amendments since 1980". Journal of Financial Economics 19, 127–168.

³⁰ See Chapter 2 of this thesis and; J.Cotter., Shivdasani, A., Zenner, M. (1997). "Do independent directors enhance target shareholder wealth during tender offers?" Journal of Financial Economics 43, 195–218.

³¹ Ibid 2 at p7

³² At first glance it may appear that the BNR accommodates for this, by allowing the board to raise defences post-bid with shareholder approval. But, for example, requiring management to convince shareholders of the validity of their long-term strategy while there is an offer on the table, that greater value will be achieved through long-term growth options and/or that any underperformance is temporary, represents a rather considerable risk on the management's part. So much so in fact, that this may deter management from committing to such a strategy or making certain types of investment (e.g. human capital) in the first place. This point is elaborated on, below

³³ Ibid 4 at p21 (HLG)

Bruno³⁴ considered the operational performance of companies which deviated from best practice under the UK Corporate Governance Code³⁵ and found that companies which deviate from established best practice and provided genuine reasons for doing so "outperform all others", including those which were fully compliant.³⁶ While this conclusion should be not extrapolated across and used as evidence in the realm of takeover defences, it is worth considering that denying companies the opportunity to deviate from the aggregate best regime, may result in preventing them from operating at their maximum potential.

The question is therefore how to design takeover rules which only allow for deviations which are 'efficient'. It is submitted that the way to achieve this is through a flexible regime, that allows for opt-outs at the company level, crafted in a way that enables those who would benefit from opt-out to successfully utilise them. At first glance this may appear similar to the current Directive, but it can be differentiated in two important ways. Firstly decision-making is removed at the Member State level and placed entirely at the company level and secondly, the opt-out is reversed, placing the onus the management to effect a change as opposed to the shareholders. The following sections will analysis why these changes would represent a better takeover regime.

The Value of Decision Making at the Company Level

An individual company's exposure to takeovers is efficient or inefficient based on a variety of factors. For example these can include the relevant industry, current market conditions or stage of a company's life cycle. These all may differ from company to company and over time, meaning so too will the company's appropriate stance to takeovers differ.³⁷ As such, it is argued that mandatory rules adopted at the Member State level which are insensitive to context are not the correct approach. The choice of defences should be made at a level which is best suited to make a nuanced assessment of the situation and relevant circumstances.³⁸

A further reason to delegate opt-out choice to the company level, is that history has shown that choice at the Member State level is largely influenced by national economic

³⁴ S. Arcot and Bruno, Valentina, One Size Does Not Fit All, After All: Evidence from Corporate Governance (January 15, 2007). 1st Annual Conference on Empirical Legal Studies, Forthcoming. Available at SSRN:<http://ssrn.com/abstract=887947>

³⁵ The Combined Code on Corporate Governance, June 1998.

³⁶ Ibid 34 at p25

³⁷ Ibid 2 at p3.

³⁸ Ibid.

protectionism.³⁹ As evidence of this, the following table used in chapter 3 shows how the BNR was implemented at the Member State level. Seven Member States became 'less bidder friendly', either through disregarding a previously mandatory BNR, or qualifying a mandatory with the reciprocity exception. The Commission even admitted that the Directive may have created new barriers to takeovers, in direct contravention of its objective of removing them.⁴⁰

More Bidder Friendly	Equally Bidder Friendly	Less Bidder Friendly
Cyprus, Finland, Latvia, Malta, Romania	Austria, Bulgaria, Czech Republic, Estonia, Ireland, Lithuania, Slovakia, Sweden, UK, Belgium, Denmark, Germany, Luxembourg, Netherlands, Poland	France, Greece, Portugal, Slovenia, Spain, Hungary, Italy

Removing the decision making element from the Member State level avoids the protectionist stance that would inevitably emerge.⁴¹ Member States' policies are prone to influence and lobbying from managers and purely national elites, but the effect is much less at the supranational level.⁴² Thus, setting the default regime at the EU level instead of the Member State level helps to alleviate this political economy problem.

5.2 Reforming the opt-out and the default Rule

It has been stated above that the most efficient choice on takeover defences is taken at the company level. The next logical step is therefore to consider what the default rules should be that companies can choose to opt-out from. The importance of default rules needs to be stressed for a number of reasons. Firstly, setting the right default rules will save on transaction costs. Opting-out of a default will bring with it associated transaction costs⁴³ (though these will be outweighed by the benefit of opting-out). One of the great values of selecting the correct default rules is that it allows parties, by remaining silent, to costlessly adopt the most efficient regime.⁴⁴ Put simply, the default rule should be selected on an aggregate efficiency basis in order to benefit the majority, thereby saving on the transaction

³⁹ Report on the Implementation of the Directive on Takeover Bids, Commission Staff Working Document, Brussels 21/02/07 at p10. See also, 'Directive on Takeover bids implemented in a protectionist way says Commission' (2007) *Company Lawyer* 28 (6) p179-180

⁴⁰ *Ibid.*

⁴¹ *Ibid* 2 at p3.

⁴² G Ferrarini and G Miller, A Simple Theory of Takeover Regulation in the United States and in Europe, Working Paper No. 139/2009.

⁴³ I. Ayres, 'Regulating Opt-out: An Economic theory of altering Rules' (2012) 121 *Yale L.J.* 2032.

⁴⁴ *Ibid* at p47.

costs of opting-out. Based on the economic conclusions drawn above, this means default rules which restrict defences.

Secondly default rules in corporate law tend to be 'sticky'.⁴⁵ Studies show that even where companies are given significant freedom of contract in corporate law, they rarely deviate from the default, to such an extent that "*default rules may often be nearly as influential as mandatory rules.*"⁴⁶

It is therefore of central importance to choose the most efficient default. The economic analysis above concluded that takeovers in the aggregate result in positive value and adopting defences results in negative value. Thus, on an aggregate efficiency basis, rules which restrict takeover defences by assigning decision-making to the shareholders should be the default. Individual companies may then choose to opt-out of these restrictions and adopt defences when it is efficient for them to do so.

One may point out that under the current takeover Directive, the regime also allows for decision making at the company level. Where the BNR and BTR are not mandatory, companies may decide to opt-in⁴⁷ and it was hoped by the Commission that this would be the case.⁴⁸ Yet to date there has not been a single observation of this occurring.⁴⁹ One may then question why such opt-ins have not taken place where it would be efficient for the company to do so, and why the proposed reform would fare any differently if defaults are indeed 'sticky'. It is submitted that the answer is because the onus to initiate the opt-out under the proposed changes would be placed on the management, unlike the present regime where it is placed on the shareholders. In the current regime when placed on the shareholders, opting-in represents such a difficult hurdle that the choice is almost rendered illusory.⁵⁰ The shareholders who stand to gain from opting-in to the BNR or BTR (i.e through capturing restructuring and disciplinary benefits)⁵¹ face significant hurdles in securing an opt-in to the BNR. Collective action problems encountered by dispersed shareholders are compounded by the fact that opt-in typically requires a supermajority vote.⁵² In short, the opt-

⁴⁵ See Henry Hansmann, 'Corporation and Contract' (2006) 8 *American Economics and Law Review*, 1.

⁴⁶ *Ibid.*

⁴⁷ Takeover Bids Directive, Article 12(2) - "Where Member States make use of the option provided for in paragraph 1, they shall nevertheless grant companies ... the option, which shall be reversible, of applying Article 9(2) and (3) and/or Article 11".

⁴⁸ J. Winter, "EU Company Law at the Cross-Roads" in *Reforming Company and Takeover Law in Europe*, (Oxford University Press, Oxford, 2004) at p18.

⁴⁹ Marccus Partners, *The Takeover Bids Directive Assessment Report*, p302 available at http://ec.europa.eu/internal_market/company/takeoverbids/index_en.htm

⁵⁰ As evidence of these difficulties, to date, not a single European company has chosen to opt-in to the BNR.

⁵¹ *Ibid* 21 at p26.

⁵² Article 12(2) of the Directive requires that the opting-in decision be taken "in accordance with the rules applicable to amendment of the articles of association".

in provision for the BNR places the burden to act on the group least equipped to do so.⁵³ The Board of course possesses the necessary means to initiate an opt-out, but they have no incentive to opt-out of a regime which already favours them, into one that does not. This is evidenced by the fact that not a single company opted in to the BNR or BTR.

According to Bebchuk and Hamdani this imbalance between management and shareholders results in a "fundamental asymmetry"⁵⁴ which needs to be addressed when designing default rules. They contend that where there is a choice between two default arrangements, one more restrictive and one less restrictive with respect to management, selecting the more restrictive arrangement is the better option.⁵⁵ This is because,

"If the restrictive arrangement is chosen, and then turns out to be inefficient, relatively little will be lost because both shareholders and managers will support a charter amendment opting out of this inefficient arrangement. In contrast, when opting out requires a charter amendment, if the non-restrictive arrangement is chosen and then turns out to be inefficient, it might often persist despite its inefficiency."⁵⁶

The complete lack of companies opting-in to the BNR or BTR is a good example of inefficient pro-management arrangement persisting. On the other hand, recent empirical studies in the US found that companies *do* opt-out of management restrictive regimes.⁵⁷ There are two further examples from Europe which provide evidence that company-level decision making will occur under the proposed regime.

Firstly, Davies et al identified significant company level decision making among CAC 40 companies in France,⁵⁸ with regards to the reciprocity exception where as of 2008, approximately twenty percent of CAC40 companies had applied it.⁵⁹ Taking up the reciprocity exception would allow target management to disapply the BNR in certain circumstances, effectively making it a 'pro-management' arrangement. This clearly shows that management will opt-out of defaults when they are biased against them.

⁵³ G. Hertig and J. McCahery, 'Company and takeover law reforms in Europe: Misguided Harmonization efforts or regulatory competition?' (2003) 4 European Business Organization Law Review 179.

⁵⁴ LA Bebchuk and A Hamdani, 'Optimal Defaults for Corporate Law Evolution' (2002) 96 Northwestern University Law Review 489 at p493.

⁵⁵ Ibid at p494.

⁵⁶ Ibid.

⁵⁷ Y. Listokin, 'What do corporate defaults and menus do? An empirical examination', (2009) 6 Journal of Empirical Legal Studies 279. It was shown that opting-out was even more frequent in the presence of statutory menu rules.

⁵⁸ Ibid 21 at p54.

⁵⁹ Herbert Smith Freehills LLP, Overview of defences used by companies listed on the CAC 40 to prevent unsolicited takeover bids, February 2008.

A second and more compelling example can be found in Italy, where the State has applied the BNR uniquely as opposed to all other Member States and in way which is in line with the changes proposed in this thesis. In Italy, the BNR is the default arrangement, from which companies may opt-out by amending their articles of association⁶⁰. The following table shows the companies which have done so:

Italian Companies which have opted-out of the BNR

Company Name	Market Value (million euro)
Fiat S.p.A	8232
Banca Carige S.p.A	2659
YOOX S.p.A	510
Marcolin S.p.A	273
Tamburi Investment Partners S.p.A	201
AcegasAps S.p.A	189
EL.EN S.p.A	52
Mondo Home Entertainment S.p.A	10
Meridie S.p.A	7

Source: Marccus Partners⁶¹

This outcome, together with the similar lack of companies opting in to the BNR or BTR in Member States where they are not mandatory, therefore matches the theoretical and empirical prediction that companies will not opt-in to management restrictive regimes, but will opt-out of them.⁶² It is therefore submitted that if the proposed changes were applied across the EU, i.e. making the defaults management-restrictive, then similar levels of company level decision making could be expected across the other Member States to those in Italy.

'Efficient' opt-outs

Both the theory and evidence indicate that Company level Opt-outs will take place. If management initiates these opt-outs however, it can be questioned whether they will be done for the 'right' reasons. In other words, opting-out of a BNR or BTR so that the company can implement a long-term strategy, or so that the board can collectively negotiate higher premiums for the shareholders may be desirable, but opting-out for self-dealing purposes (i.e. managerial entrenchment) would not be. While it may be unrealistic to assume that *only* the desirable opt-outs will occur, it is suggested that the majority of instances will be desirable for the following reasons.

⁶⁰ LEGISLATIVE DECREE No. 58 OF 24 FEBRUARY 1998 Italian Consolidated Law on Finance, Article 104.

⁶¹ Ibid 25 at p190.

⁶² Ibid 2 at p39.

Firstly, shareholders bodies are made up of increasingly sophisticated investors.⁶³ The adoption of takeover defences is generally associated with negative returns for shareholders⁶⁴ and therefore likely to make shareholders wary of approving amendments to the articles of association which allow for takeover defences. However, a study carried out by Arcot and Bruno, shows that where companies deviate from best practice and provide genuine reasons for doing so, they have the highest performance metrics of all companies, even the ones that fully comply.⁶⁵ Thus, where management is able to present convincing reasons for an opt-out, shareholder approval should act as an effective screen for 'efficient' scenarios.

Secondly, seeking shareholder authorisation for allowing defensive action by opting-out is not a straightforward task. If management cannot present satisfactory reasons for opting-out it carries the risk of shareholders rejecting the resolution, in which case the management may simply have signalled to the market that they are a potential takeover target.⁶⁶ The risk carried with such outcomes will serve to constrain instances of managerial opportunism.

Conclusions on a 'neutral' approach

A takeover regime which sets default rules at the supranational level, but allows for opt-outs at the company level, creates an arrangement which neither promotes nor impedes takeovers but allows for a tailored decision to be made at the level best suited to make a nuanced assessment of the particular circumstances.⁶⁷

This places central importance on choosing the 'correct' default rules. Selecting the rule which benefits the majority of companies means only a minority of companies will need to opt-out, saving on transaction costs. Further, the costs associated with opting-out will only be borne in the presence of offsetting benefits. Unlike the current regime implemented by the Directive, it has been demonstrated why the proposed opt-out regime will actually see instances of company level decision-making. Theory explains that management will not opt-in to a regime which restrains them, but will opt-out of one that does. Empirical studies as

⁶³ See Luca Enriques, nr 2, above." By the late 2000s, for example, institutional investors held over 70 percent of the outstanding shares of the 1000 largest U.S. public corporations and the ten largest institutions owned more than 25 percent of the outstanding shares in many large public corporations." at p3.

⁶⁴ P. Gompers, Ishii, and Metrick, 'Corporate Governance and Equity Prices' Quarterly Journal of Economics, Vol. 118, No. 1, pp. 107-155, (2003). Available at SSRN: <http://ssrn.com/abstract=278920>

⁶⁵ Ibid 34 at p25.

⁶⁶ Ibid 21 at p46. Davies also notes that similar resolutions for pre-bid defences have in the been withdraw for fear that they would not be accepted by the shareholders. Resolutions for defensive measures which were passed also had some of lowest levels of support.

⁶⁷ Ibid 2 at p3.

well as the example of Italy provide real-world evidence of this. The 'opt-in' mechanism under the current Directive was a result of political necessity. Making Articles 9 and 11 (BNR and BTR) optional at the Member State level was not the regime that the Commission wanted to implement, but it was the only way that a Takeover Bids Directive would be accepted in the political-economy climate. Legislating for opt-ins where a country chooses not to apply the BNR and/or BTR was an attempt by the Commission to counteract this political economy problem and salvage as much of their initial objective as possible - namely facilitating takeover activity across the EU.⁶⁸ Therefore, the current opt-in regime has its basis in a late-stage political compromise as opposed to sound economic or legal theory. The combination of legislative fatigue after years of negotiations and failed attempts, along with, in the words of European officials, the need to "terminate this never-ending story"⁶⁹ and the feeling that "half a loaf was better than none"⁷⁰, has resulted in a sub-optimal European takeover framework. It is submitted that the proposed regime therefore represents a positive advance for European takeover regulation.

5.3 Reciprocity

A further aspect of the BNR and BTR which needs to be addressed in the case for reform is the reciprocity exception introduced by Article 12 (3) of the Directive. Where a target company has chosen to opt-in to the reciprocity exception, it allows them to disapply the BNR and/or BTR if the bidder is themselves not subject to the same rules. The reciprocity exception is authorised by the companies' shareholders. Such authorisation must be made no earlier than 18 months before the bid is made public by the offeror company.⁷¹

Like the 'opt-in' system, the reciprocity exception was borne out of political concerns rather than sound legal or economic theory⁷² and was motivated by resistance from interest groups who opposed pro-takeover regime changes.⁷³ There were concerns that a BNR and BTR would put them on an unlevel footing as opposed to non-EU firms, in particular from the US, where they enjoy much greater access to takeover defences, giving the US firms a

⁶⁸ See chapter 3 of this thesis, section entitled 'Aims of the Board Neutrality Rule' which concludes that the objective of the Directive was to facilitate takeover activity. See also P. Davies, nr21, above at p5.

⁶⁹ B. Clarke, 'Takeover Regulation: Through the Regulatory Looking Glass (July 24, 2007). CLPE Research Paper No. 18/2007 at p23. Available at SSRN: <http://ssrn.com/abstract=1002675>

⁷⁰ L. Klaus-Heiner COD/2002/0240, EP: legislative opinion, 1st reading or single reading (16/12/2003).

⁷¹ Takeover Bids Directive, Article 12(5).

⁷² See Chapter 3 of this thesis, section entitled 'Reciprocity'.

⁷³ Ibid 2 at p37.

perceived 'unfair advantage'.⁷⁴ The High Level Group were of the opinion that no such advantage would exist, but the political necessity of addressing these concerns in order to achieve the Directive overrode the High Level Group.⁷⁵ Indeed it is submitted that in the proposed reform of the BNR and BTR, the reciprocity exception should be removed entirely. There are two reasons for this.

Firstly, it appears to have no readily identifiable economic benefits, but presents a number of drawbacks. The concept of reciprocity should provide a level playing field - in theory only companies which are contestable (because they are subject to the BNR and BTR) should be able to launch hostile bids for other companies. As Becht points out however, the reciprocity exception does not come close to achieving this.⁷⁶ For example, a company controlled by a majority blockholder which is subject to both the BNR and BTR is not itself contestable, yet is not inhibited in any way by the reciprocity exception. In other words, being subject to the rules does not automatically make a company contestable. In addition, the reciprocity exception can create inefficiencies for both bidders and targets. It unduly restricts the number of potential offerors, by artificially reducing the pool of potential bidder companies to those which are themselves open to hostile bids.⁷⁷ This not only decreases overall takeover activity but also reduces the scope for instances of competing bids, to which the empirical evidence attaches higher bid premia. Hence, reciprocity is likely to hurt the minority shareholders the Directive was intended to protect.⁷⁸ On the other side of the same coin, reciprocity may hinder corporate restructuring. Suitable bidders which are not subject to the BNR or BTR (non-listed companies for example) may be prevented from acquiring targets which apply reciprocity, possibly leading to less suitable bidders acquiring them instead.⁷⁹

Secondly, under the proposed regime reciprocity becomes somewhat superfluous in nature - companies will have the option to opt-out of the default rules if they do not wish to be contestable, unlike under the current directive which does not allow for opt-out where the Member State has made the BNR or BTR mandatory.

In summary, the reciprocity exception appears to be ill-grounded. At best it represents an unnecessary complication that provides no real benefits. At worst it actively distorts efficient

⁷⁴ . High Level Group of Company Law Experts, *Report on Issues Related to Takeover Bids*, Brussels 10 January 2002 at p42.

⁷⁵ Ibid.

⁷⁶ M. Becht, 'Reciprocity in Takeovers' (October 2003). ECGI - Law Working Paper No. 14/2003. Available at SSRN: <http://ssrn.com/abstract=463003>.

⁷⁷ B. Clarke "Articles 9 and 11 of the Takeover Directive (2004/25) and the Market for Corporate Control" [2006] *Journal of Business Law* at p373.

⁷⁸ Ibid 76 at p12

⁷⁹ Ibid 76 at p12-13.

corporate restructuring and results in lower bid premiums for target shareholders. Based on this, it is argued that the exception should be removed from the Directive entirely.

Reforming the Directive

5.4 Article 9 - Board Neutrality

The case has been presented above as to why a reform of the BNR would be desirable for the EU. The current implementation of the BNR did not achieve the goal of creating a level-playing field, due to the optionality and reciprocity provisions. Moreover, it cannot be said that it has facilitated an active market for corporate control. In fact, the opposite may be true. Chapter 3 of this thesis demonstrated that it has been implemented in a protectionist manner by the Member States, causing some to move away from a previously mandatory BNR, while others qualified a mandatory BNR with the reciprocity exception.⁸⁰

Not a single observation has been recorded of a company opting-in to the BNR, suggesting that the opt-in mechanism is not adequate. Certain companies are unable to opt-in to a regime which would be efficient for them, while others face the opposite problem of being subject to a BNR and unable to opt-out. The culmination of this leads to the conclusion that the current BNR is sub-optimal and could be reformed to a more efficient regime.

The economic and empirical evidence above counsels in favour of an open market for corporate control that restricts takeover defences.⁸¹ But certain instances have been identified where takeover defences are efficient for companies. There is more than one way of organising efficient production in a capitalist system. It is therefore submitted that facilitating an open market for corporate control in all instances is not desirable. In a minority of cases, companies should be able to deviate from this where it is efficient for them to do so. These instances will vary over time and between market sectors, leading to the conclusion that the decision of when to deviate from the default is best made at the individual company level.⁸² Moreover the corporate cultures are varied across Europe, with the 'varieties of capitalism' literature drawing a distinction between liberal and co-ordinated market economies.⁸³ Though certain types of company tend to be the norm in particular States, there remains a minority which diverge from the norm. Regardless of whether the

⁸⁰ See Table 1, above, showing which countries have become more or less bidder friendly. See also Chapter 3 for a more comprehensive review of this.

⁸¹ In addition to the above analysis, see Seretakis, above nr 8, for a summary of the economic benefits of a management restrictive regime.

⁸² Ibid 2 at p3-4.

⁸³ P Hall and D Soskice, 'Introduction to Varieties of Capitalism' in P Hall and D Soskice (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (OUP, Oxford/New York 2001)

divergent companies are dispersedly held in typically blockholder countries or vice versa, the point is that company-level decision making respects these differences and does not result in the costs associated with a State-wide mandatory rule which only serves the majority at the detriment of the minority. Further, Member State decisions tend to be influenced by economic nationalism and should be removed from the equation.⁸⁴

All Member States should therefore apply a BNR as a default rule, with companies able to opt-out by amending their articles of association by a simple majority. The hurdle to opting out of the BNR should not be set too high. As discussed above, corporate law defaults tend to be sticky, so the frequency of company opt-outs is not expected to be high. Companies where it would be efficient to opt-out should not be deterred from doing so by setting a barrier which is excessive.

The majority of companies will therefore be subject to the BNR, but where management is able to present convincing reasons to shareholders that defences would be in the best interests of the company, it is predicted that company level opt-outs will occur. As discussed above, a company's efficient exposure to takeovers will vary over time and at different stages of a firm's lifecycle. Closer to the IPO stage for example, a company's intrinsic value may depend heavily on future growth options and management may request defences to implement long-term plans. For instance, to make investments in R&D and/or specific human capital, which may see greater shareholder value over a longer investment horizon. Alternatively management may be better informed than the shareholders to reject a bid which does not accurately value the expected future growth.⁸⁵

However there is cause for concern that a company which opts-out for a genuine efficiency reason, will retain this arrangement after the original efficiency has expired. If shareholders approve a resolution allowing management to entrench themselves, such entrenchments are likely to remain in place after they have outlived their value.⁸⁶ It was demonstrated above why a company will not opt in to a management restrictive regime and it will likely remain in place due to the shareholder's inability to initiate a change (due to rational apathy and collective action problems). It may be efficient for a company to opt-out of the BNR for a period of time, but as argued above, conditions will vary over the lifecycle of a firm and this period may only be temporary. In the instances that it is indeed temporary, a switch *back to*

⁸⁴ Ibid 21.

⁸⁵ Ibid 2 at p11

⁸⁶ L. Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713 (2003) at p752.

the BNR would be desirable, but almost certainly would not occur because dispersed shareholders have been demonstrated to be unable to initiate a regime change.⁸⁷

In order to counteract this, it is submitted that when a company passes a resolution opting-out of the BNR, this only has effect for a limited (albeit lengthy) period of time. Once the period of time elapses, the company automatically opts back in to the BNR. This will be further discussed below, but for now, this period can be given a maximum value of 4 years.⁸⁸

The expiration of this period removes the need for shareholders to bring an action by themselves, thereby sidestepping the collective action problems they face. In the case where it remains continually efficient to opt-out of the BNR, management can propose another resolution at any point, which extends the period by a further 4 years from the date of the second resolution. For example a company which passes a resolution to opt-out in April 2015, will not be subject to the BNR until April 2019. If the management proposes another resolution in April 2018 which is passed by the shareholders, the BNR will then not apply until April 2022. If the 2018 resolution does not pass, then the company will automatically opt back in to the BNR in 2019. This resetting mechanism is designed to ensure that defences are only possible while they serve shareholder value.

A period of 4 years has been suggested. This period needs to be sufficiently great enough to encourage management to credibly commit to a long-term strategy or make investments in human capital, which may not produce short-term gains but offers greater shareholder value long-term. 4 years should be either long enough to implement such strategy, or long enough to demonstrate to shareholders the value of the takeover defences. If these benefits can be shown to shareholders, then management should have no problem passing another resolution granting another 4 years 'extension'. If however they cannot, shareholders are unlikely to pass another resolution and the company will opt back in to the BNR after the 4 year period, once again opening up the market for corporate control.

Of course if this proposal were to be taken any further, a detailed study and consultation on assessing the length of a suitable time period would need to be carried out. Finding the equilibrium between furnishing management with enough time to execute a strategy, but short enough to prevent opportunistic managerial entrenchment would be the goal.

⁸⁷ This mirrors the current implementation of the Directive where no examples of companies opting-in to the BNR (or BTR) have been observed).

⁸⁸ The period of time should be great enough to allow Directors to implement long-term strategy and make specific investments without having to be overly concerned with short-term results. However 4 years is currently an arbitrarily chosen number. Careful consultations should be made as to what the appropriate time should be in the case of a reform. See also Davies et al, nr 21 above, for a similar suggestion.

In summary, a pro-management arrangement would need continual shareholder approval to remain in place, otherwise it automatically reverts back to the pro-shareholder default.

5.5 Article 11 - The Breakthrough Rule

As discussed in chapter 4, the BTR was envisaged by the Commission as a means of 'breaking-through' defences which allow a controlling shareholder to maintain control despite not having proportional cash-flow rights.⁸⁹ It effectively removes the decision making power from a controlling shareholder and transfers it to all the shareholders on a proportional 'one share one vote' basis. This opens up the market for corporate control in companies where there are disproportionate control rights assigned to a shareholder (for example with dual class shares / multiple voting rights) thereby facilitating takeovers and promoting active capital markets across the EU.

However the vast majority of Member States chose not to implement the BTR. Only Lithuania, Estonia and Latvia implemented the BTR in response to the Directive and their capital markets make up only 0.071%,⁹⁰ a tiny fraction, of the EU total. Moreover, not a single company in the other Member States has chosen to opt-in to the BTR. In short, there has been a total lack of transposition of the BTR which suggests it is inefficient in its current form.⁹¹

This begs the question of whether the BTR can benefit from reform. There have been calls from some spheres for the BTR to be made mandatory across the EU. On the other hand, this thesis has so far advocated that flexible rules which allow companies to choose their own level of contestability represent the best regime possible for EU takeover regulation. Based on this it will be shown why a mandatory BTR would not be a desirable reform. However it is also submitted that reforming the BTR in the same way as BNR, by making it a default rule which allows for company level opt-outs, would not be a feasible course of action either. Instead the BTR should at most play only a very limited role in EU takeover regulation.

The Case Against a Mandatory Breakthrough Rule

⁸⁹ J. Coates IV, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, in *Reforming Company And Takeover Law In Europe* 677,(Guido Ferrarini et al. eds., 2004) at p 683.

⁹⁰ See Chapter 4 of the thesis, above. Data taken from 2012 Financial Year.

⁹¹ *Ibid* 49 at p195.

Chapter 4 identified a number of issues with the current formulation of the BTR under Article 11. While these issues could theoretically be addressed so that the BTR could achieve its aim of opening the up the market for corporate control, it is submitted that even in this hypothetical scenario there is a lack of justifiable evidence that the BTR would produce positive results for the EU. Indeed the High Level Group which advocated the rule has been accused of dealing in summary fashion with the question of whether the BTR is "necessary, justifiable or even advisable."⁹² It seems the BTR would produce few certain benefits but cause significant certain costs.⁹³ The point is, that while the current formulation of Article 11 is deficient, the BTR itself does not appear to be well grounded and difficult to justify on an efficiency basis. Thus, even if the deficiencies were 'fixed', the BTR would not be a beneficial rule for EU takeover regulation. The following sections will briefly discuss the substantive deficiencies of the BTR under Article 11, before assessing why the BTR itself does not appear to be well grounded.

Issues specific to the Article 11 BTR

The issues specific to the current formulation of the BTR under Article 11 can be summarised as follows:

- uneven application with regards to legal structures, allowing for evasion (i.e. applying to multiple voting shares, but not ceiling shares),
- evasion through factual structures (Pyramidal groups, cross-shareholdings),
- uncertainties over compensation.

Firstly, the BTR appears to apply unevenly towards legal structures which separate ownership from control. While it seems the BTR will apply to multiple voting rights,⁹⁴ other control enhancing mechanisms (CEMs) which have the same effect, such as ceiling shares or non-voting receipts, remain outside the scope of the BTR. Such an uneven application appears to affect certain Member States more than others depending on which CEMs are prevalent in a given Jurisdiction. The Nordic countries tend to make heavy use of multiple voting rights and consequently the BTR would have a much greater effect there, than in France for example, where ceilings shares are a more common CEM. Under the current Article 11 BTR, companies wishing to 'evade' the rule could do so by using a form of CEM

⁹² P. Mulbert, "Make it or Break it" in G. Ferrarini, K. Hopt, J. Winter and E. Wymeersch (eds), *Reforming Company and Takeover Law in Europe* (OUP 2004) at p718.

⁹³ *Ibid* 89 at p6.

⁹⁴ C. Clottens & Geens, K "One Share – One Vote: Fairness, Efficiency and (the Case for) EU Harmonisation Revisited" (2010) at p7. Available at <http://ssrn.com/abstract=1547842>.

which is outside its scope. It was concluded in Chapter 4 that there are no justifiable economic grounds for this discrepancy - instead it appears to be a result of political opportunism by certain Member States.⁹⁵ From a legal standpoint it would be relatively straightforward to remedy this, by reforming the BTR to apply to the CEMs it currently does not. This would prevent certain companies from 'evading' the BTR in this manner. However from a political economy perspective this stands differently and reform would run into the same political problems that caused the uneven application in the first place. Nevertheless, for now the purpose is to show that even in a political vacuum, a hypothetical BTR with its deficiencies 'fixed' would still not have a clear positive impact on EU takeover regulation.

Even if the above deficiency of the legal structures could be remedied, companies could still evade the BTR by using factual structures. Cross-shareholding and pyramid groups both produce the same effect of disproportionately separating capital and control. The BTR would need to be either 'reformulated in a radical way' to deal with pyramids,⁹⁶ or simultaneous legislation introduced which prevents their use as a CEM. To be sure this would be a highly complex and difficult task and beyond the scope of this thesis, but theoretically it could be accomplished.

The final issue is of compensation. Article 11 (5) provides for equitable compensation for holder's of rights which are broken through. Yet there is no method of quantification, delivery, or even which constituency bears the cost, provided for by the Directive. Not only does this provide a great deal of uncertainty and variation between Member States, but the timing of a tender offer is crucial⁹⁷ and delays in the quantification process could prove fatal to a bid. Moreover, if the cost of compensation is to be borne by the bidder, this may well have a chilling effect on the number of bids, the opposite of the desired goal of facilitating takeovers.

The above represent the three main criticisms that can be levelled at the substantive text of the BTR under Article 11. They constitute three significant deficiencies of the rule which would make it unsuccessful if it was to be made mandatory in its current form.

Hypothetically, though difficult, each could be remedied. But it is argued that even if these deficiencies were corrected, the underlying rationale of the BTR is not well grounded and thus should not be implemented within the realm of takeover regulation.

⁹⁵ T. Papadopoulos, "Legal Aspects of the Breakthrough Rule of the European Takeover Bid Directive". *takeover regulation: a legal approach*, Icfai Books, Icfai University Press (IUP), Icfai University, 2008 at p10.

⁹⁶ Ibid 94 at p26.

⁹⁷ J. Rickford 'Takeovers in Europe - shareholders decisions and open markets - a UK Perspective' in J. Grant (ed), *European Takeovers: the Art of Acquisition* (1st ed Euromoney Books) 2005 at p72.

The Breakthrough Rule does not appear well grounded

As mentioned above, the BTR is directed primarily at companies where a shareholder exercises control disproportionately to their cash flow rights, through a dual class share structure. The structure is 'broken through' by selectively imposing a 'one share one vote' mandate pending a takeover bid or once a takeover bid is successful.⁹⁸

In order to demonstrate why the BTR does not appear well grounded on an efficiency basis, it first needs to be briefly discussed why such disproportionate controlling shareholders persist in public firms in the first place.⁹⁹ The answer seems to be the 'private benefits of control' (PBC) that are enjoyed by the controller. As defined by Coates, they are:

*"any benefits that a control person derives from their control of a firm that are not shared proportionally with non-controlling shareholders"*¹⁰⁰ There has been much academic debate on the topic and composition of PBCs,¹⁰¹ but they can generally be categorised into three separate types: bad (inefficient) PBCs, good (efficient) PBCs and inherent PBCs.

The bad kind constitute a transfer of value from minority shareholders to the controller, where the loss suffered is greater than the gain. Examples of this include self-dealing, excessive risk aversion, operational strategies based on personal preference, excessive (often hidden) compensation¹⁰² and the transfer of profits or assets for personal gain, known as 'tunnelling'.¹⁰³

The good types of PBC are transfers where the gain by the controller is greater than the loss of the minority (they can also encompass situations where the controller gains and the minority shareholders suffer no loss, or a gain themselves). PBC could be considered to be efficiently extracted in the presence of larger synergy gains through participation in a corporate group in which the controller also holds a stake, as the controller benefits while also maximising firm value.¹⁰⁴ Alternatively, the opportunity to pursue a venture may arise to

⁹⁸ Ibid 2 at p38.

⁹⁹ Ibid 89 at p690.

¹⁰⁰ Ibid 89 at p690.

¹⁰¹ See e.g. L. Bebchuk, "A Rent-Protection Theory of Corporate Ownership and Control", NEBR Working Paper 7203 (1999) on the topic of 'bad PBCs'; H. Demsetz and K. Lehn, The structure of corporate ownership: Causes and consequences, 93 J Pol Econ 1155 (1985) on 'good PBCs', or what they term "amenity potential".

¹⁰² Ibid 89 at p14.

¹⁰³ S. Johnson, R. La Porta, Lopez de Silanes, and A. Shleifer, Tunnelling (January 2000). Harvard Institute of Economic Research Paper No. 1887. Available at SSRN:<http://ssrn.com/abstract=204868>

¹⁰⁴ L. Zingales, 'Insider ownership and the decision to go public', 62 Rev Econ Stud 425 (1995).

a controller by virtue of his position, and pursuing it through the firm generates value for all shareholders.¹⁰⁵

'Inherent' (also known as non-pecuniary) PBCs are those that accrue to a controller by virtue of his position and are non-transferrable - they cannot be shared with minority shareholders.¹⁰⁶ An often used example is that of ownership of a major newspaper or media company, which grants the owner social and political influence.

Dual class share structures are used so that a controller can enjoy PBCs without needing to retain a majority of the cash flow rights. By using multiple vote shares, the controller can have the majority voting power and still raise more capital by selling off the majority of equity. Since they have the majority voting power, they can easily prevent a takeover from happening by simply not tendering their shares. The BTR would undo this structure by implementing a temporary 'one share one vote' mandate, allowing all the shareholders to proportionally decide on the merits of a bid. From a policy perspective, the question is whether it is better to implement the BTR and allow all shareholders to decide on the bid proportionally, or to allow the controlling shareholder to decide on the bid.

It is submitted that there is not sufficient economic justification for implementing a BTR. The benefits are unclear, but any such benefit would be outweighed by certain costs. This is because of the following reasons. Enriques et al have determined that a controller will reject value-decreasing takeover offers, and accept value-increasing ones (the two socially ideal outcomes) *except* in one scenario, which is where PBCs are extracted *inefficiently* by the controller.¹⁰⁷ Here the takeover bid, which would represent a net gain for all the shareholders, undervalues the controllers PBCs and thus is rejected.

The problem is that by imposing 'one share one vote' at the takeover stage, the BTR would eliminate the inefficiencies *but also* the benefits of dual class structures. The benefits being: net wealth gains where 'good' PBCs are extracted; the monitoring of management by the controller¹⁰⁸ and the rejection of value-decreasing bids. Moreover, at the IPO stage when a company first goes public, it is not problematic for the owners to choose a dual class

¹⁰⁵ The purchase of Tyco convertible bonds by Berkshire Hathaway is an example of this given by J. Coates. See nr89 above at p13.

¹⁰⁶ R. Gilson, 'Controlling shareholders and corporate governance: complicating the corporate taxonomy', 119 Harv L Rev 1641 (2006) at p1667.

¹⁰⁷ *Ibid* 2 at pp14-19.

¹⁰⁸ L. Zingales, & A. Dyck. (2004), "Private Benefits of Control: An International Comparison", *The Journal of Finance*, Vol. 59, No. 2, pp. 537-600.

structure because they themselves will bear the cost.¹⁰⁹ The markets apply a discount to lower voting shares, and with this knowledge owners who go public with a dual class structure knowingly accept the lower capital. Thus, it can be said these deviations from 'one share one vote' are efficient because it is the owner (who becomes the controller) who bears the cost.

Thus there are benefits of dual class structures which would be lost if a BTR was implemented. On the other hand, a BTR would remove the inefficiencies caused by bad PBCs in dual class companies. If there was compelling evidence that such bad PBCs were a widespread and significant problem in the EU then it could be argued that implementing the BTR to eliminate the inefficiencies would outweigh losing the benefits. However the empirical evidence does not show this. In countries with high quality corporate law and effective courts, bad PBCs are usually not substantial.¹¹⁰ Generally, this is the case for EU Member States and the empirical studies carried out support this, showing that companies with dual class stock do not underperform compared to those which apply 'one share one vote' - suggesting PBCs are not extracted to inefficient levels.¹¹¹

A further cost of implementing the BTR is that it would cause controllers who wish to retain their control to attempt to evade it. Pyramids currently constitute an 'easy escape'¹¹² and have multiple costs at a welfare level. Firstly, reorganising to a pyramidal group would bring transaction costs as well as lawyers and bankers fees, which can be significant. Secondly they are more opaque than dual class structures and therefore harder for investors to price. Finally, it would distract senior management from their day to day duties which would have a negative impact on regular business operation.¹¹³ Moreover any reform of pyramidal groups would be, by the Commission's own acknowledgement, expensive and complicated.¹¹⁴

Even if the 'problem' of pyramids as CEMs could be solved as discussed above, the introduction of a BTR may simply discourage firms from ever going public in the first place, in

¹⁰⁹ G. Ferrarini, 'One Share - one vote: A European Rule?' (2006) EGCI Working Paper Series n58/2006 at p11.

¹¹⁰ Ibid 2 at p17.

¹¹¹ For studies on the incidence of PBC, see J. Coates nr 89 above, at p17; C. Rose, 'Corporate finance Performance and the use of takeover defences', 13 *European J L&Econ.* 91 (2002); for US firms, see L. Field and Karpoff, 'Takeover Defenses of IPO Firms (2002). *Journal of Finance*, Vol. 57, No. 5, October 2002. Available at SSRN: <http://ssrn.com/abstract=286923> but c.f. Ehrhardt, Olaf and Nowak, Eric, Private Benefits and Minority Shareholder Expropriation (or What Exactly are Private Benefits of Control?) (June 2003). EFA 2003 Annual Conference Paper No. 809. Available at SSRN:<http://ssrn.com/abstract=423506> who find that German firms with DC structures underperform.

¹¹² Ibid 94 at p23.

¹¹³ Ibid 2 at p12

¹¹⁴ E. Berglöf and M. Burkart, 'European Takeover Regulation' (2003) 36 *Economic Policy* 173.

order for the founders to retain control. Founders may well avoid capital markets if it means they cannot preserve their control. Instead they would seek costlier sources of financing, hampering growth and development and resulting in a net loss to social welfare. In addition, the need to pay compensation to a controller for broken-through rights would add further cost to a bid, and is likely to have a chilling effect instead of facilitating takeovers.

It is therefore submitted that the benefits of a BTR are questionable, but the costs are certain. Based on this it can be concluded that a mandatory BTR would not be a positive step for EU takeover regulation.

A default BTR?

It has been argued that a mandatory BTR as with a mandatory BNR, is not the ideal approach for EU takeover regulation. But while the BNR can benefit from being made a default rule at the European level from which companies can opt-out, the same is not true for the BTR.

It was stated above that the situation in which a BTR is beneficial involves a shareholder, who exercises control disproportionately, inefficiently extracting PBCs from the rest of the shareholders while being immune from a hostile bid. A default rule would of course offer no value here, because such a controller would simply be able to opt-out. Indeed, it would be irrational to allow a controller to decide on the limitation of their voting rights in case of takeover.¹¹⁵ While additional hurdles to opting-out such as majority of the minority voting may alleviate this problem, the risk it would add of being unable to opt-out would be regarded by a controller in the same way as a mandatory BTR. As a consequence the same problems would be encountered - controllers choosing to evade the BTR via a pyramid group, or avoiding capital markets altogether. In summary, it therefore seems that neither a mandatory or a default BTR would bring benefits that would outweigh the inevitable associated costs.

There may however be some useful scope for a Menu-rule BTR which acts as a sunset clause as first suggested by Professor Coates¹¹⁶ and developed by Enriques et al who state:

¹¹⁵ Ibid 49 at p312.

¹¹⁶ Ibid 89 at pp707-709.

"In a setting where the founder believes that the market will undervalue the company's stock because of its dependence on future growth options, a BTR becoming effective at a specified date (e.g., ten years after the IPO) would both credibly inform the market of the reason for the departure from 1S1V [One share on vote] and provide a time frame in which growth options will have to materialize, in effect buying the founder only time. While we have shown earlier that a leveraged control structure always gives the controlling shareholder an option to give it up if the price of the leverage as reflected in the market discount gets too high, opting into a sunset-style BTR may allow the controlling shareholder to avoid some or all of the discount that would reflect the anticipation of private benefit extraction."

The fact that the BTR is already a menu rule which no companies have chosen to opt in to may lead to one question if this reformulation will fare any better. Unlike the current BTR however which relies irrationally on a controller to place restrictions on their own control, this 'sunset BTR' does provide a benefit to the controller and is therefore significantly more likely to see the light of day on a corporate charter.

Summary

The BTR was an innovative and forward-thinking concept in the realm of takeover regulation, but such a radical idea needs clear theoretical and empirical justification before being implemented. Ultimately the BTR does not stand up to this requirement. A reform of the Directive should therefore remove Article 11 as it currently stands. In its current form it is virtually unused and reforming it into a mandatory or default rule would not provide clear benefits, but would incur associated costs. Instead it may find better use as a 'sunset' style menu rule which companies can opt-in to, as put forward by Enriques et al. While such a rule may only see limited use, it would incur no social welfare costs as it is the company owner who chooses to place a limit on his own voting power.

In situations where a controller inefficiently extracts PBCs, the BTR would enable a bidder to circumvent the controller and effectively make a bid to dispersed shareholders by imposing 'one share one vote'. However it is submitted that the BTR only provides a second-best, *ex post* solution to the problem of inefficient PBCs while also incurring costs. Instead, high quality corporate law and effective courts which prevent controllers from extracting PBCs

inefficiently would be a more desirable solution.¹¹⁷ But such a discussion is beyond the scope of this work. For now it can be concluded that neither a default nor mandatory BTR is optimal for EU takeover regulation.

¹¹⁷ Gilson, Ronald J. and Schwartz, Alan, Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review (August 14, 2012). Yale Law & Economics Research Paper No. 455.

Concluding Remarks

This thesis began by tracing the arduous and long winded path to adoption that the Directive took, highlighting the difficulties that legislators must overcome in this area. Public companies often represent a significant proportion of a nation's economy, understandably leading to national protectionist influence which can create barriers to legal reform. Moreover, incumbent interest groups in this area are competent, financially well-equipped and possess a sufficient interest to block legal innovations. Ultimately the Takeover Directive was fraught with political compromise resulting in the Articles regulating takeover defences being rendered optional and the concept of reciprocity introduced. Accordingly the formulations of the BNR and BTR do not have their foundations in sound economic or legal theory and as such, this thesis has attempted to show that they do not constitute the optimal regime for European takeover regulation.

Instead, the situation has been assessed through an efficiency lens. The efficient level of exposure to takeovers will vary from company to company, across industry sectors and Member States. Further, any given company's efficient exposure is not a constant. It will change over time at different stages in the company's lifecycle and may depend on current market conditions. Takeover rules which suit a company at the IPO stage in an 'economic boom' may not be efficient for the same company a decade later in a financial crisis after it has matured. In sum, the constituency best placed to decide what level of takeover exposure a company has, is the company itself.

Instead, the Directive placed this decision at the Member State level. The result was that the majority of Member States retained the status quo, and some even departed further from a takeover friendly regime. Opt-ins were placed at the company level as well, yet with the benefit of hindsight, one can say that these opt-ins are in reality unworkable - illustrated by a complete lack of observable opt-ins across the entirety of the EU.

In light of this, the thesis has suggested a number of reforms. Based on value justifications, it is submitted that both the BTR and the reciprocity exception should be removed. With the BTR, there is a lack of clear evidence that such a rule, either mandatory or default, would provide economic benefits that are outweighed by the costs. Reciprocity similarly seems to lack a sound economic justification and can best be seen as a result of political compromise caused by legislative fatigue and the sentiment of the Rapporteur that 'half a loaf is better than none'.

It has hopefully been demonstrated that the BNR can benefit from being implemented instead as a default rule across the EU. Removing the Member States from the decision-making equation and placing it solely at the company level allows for an opt-out system which, unlike the current system, will see observable action at the company level. This is achieved by reversing the default regime, and placing the burden to alter the default on the management of the company as opposed to dispersed shareholders, who are poorly equipped to initiate change. It has been argued that this represents the optimal regime as deviations from the default will only take place where it is efficient to do so. Further, such deviations have in effect a time-limit within which they can be renewed, or expire. There will never be a perfect takeover regime which allows for only value-enhancing takeovers to go through while preventing value-decreasing ones. But this should not deter regulators from striving for the best regime possible. It has been said that 'the perfect is the enemy of the good' and in this regard, the takeover Directive represents an important step on the path to an optimal European regime. With the benefit of hindsight, and the knowledge gained through how the Directive has been applied, this thesis has attempted to argue in which direction future steps should continue to be taken.

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