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WHY CONTINENTAL EUROPEAN TAKEOVER LAW MATTERS

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Abstract: This paper addresses the following question in the context of considering the recommendations of the High Level Group of Company Law Experts on Takeover Bids: Why does Continental European takeover law matter given the concentrated ownership structure of most Continental European firms? In answering this question, the paper discusses the interaction between takeover rules and ownership structure and the possible lessons that can be drawn from the British and American experience with takeover regulation. While a ban on the use of defensive tactics without shareholder approval (possibly in conjunction with a mandatory bid rule) can theoretically have the effect of either encouraging or discouraging the adoption of dispersed-ownership structures, the empirical evidence suggests that the former would be the more likely result. Moreover, the British and American experience highlights the importance of adopting a takeover regime earlier rather than later in time.

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WHY CONTINENTAL EUROPEAN TAKEOVER LAW MATTERS

ALLEN FERRELL

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I. WHY WORRY ABOUT CONTINENTAL EUROPEAN TAKEOVER REGULATION?

At first glance, it is not obvious why takeover regulation in Continental Europe is a particularly important topic. The ownership structure of firms in Continental Europe, compared to that of their U.S. and British counterparts, is very concentrated. While corporate ownership structures have seen changes over the last ten years, concentrated ownership is still the norm in Continental Europe. Berglof and Burkart, for instance, report that more than 50% of listed, non-financial companies in Austria, Belgium, Germany and Italy have a single control block with a majority of voting rights. In contrast, only 3% of companies in the United States and the United Kingdom have a single control block with a majority of voting rights.¹

Takeover rules governing the use of defensive tactics by target management, along with many other so-called “technical barriers,”² are critically important when there is a wide dispersion of ownership and control rights. If a company has a controller, whether that control is due to a large ownership stake or disproportionate voting rights, then these rules rapidly fade in importance. An acquisition will only occur when – and only when – the controller consents or has somehow lost control.

First impressions can be deceiving. The recommendations contained in the High Level Group of Company Law Experts on Takeover Bids (hereinafter, the Winter Report), an important set of recommendations produced by a distinguished committee of

¹ Erik Berglof and Mike Burkart, *European Takeover Regulation*, 36 *Economic Policy*, April 2003, at 179. In more than 50% of non-financial, listed companies in Netherlands, France, Spain and Sweden there is, respectively, a single control block with 43.5%, 20%, 34.5% and 34.9% of the voting rights.

² “Technical barriers” typically refer to those barriers to takeovers that are the result of various statutes and regulations that allocate power between various participants in the corporation. “Structural barriers,” on the other hand, refer to barriers resulting from such economic phenomena as ownership concentration.

company law experts, would, after all, affect some European companies.³ This would still be true even if the Winter Report's proposed "break-through rule" – a rule that would permit a bidder that acquired a certain percentage of the risk-bearing capital of a firm to acquire control of that firm – were limited to only those bidders who obtain 75% of the risk-bearing capital of a firm.⁴ Some recent empirical evidence, utilizing data on European firm ownership and control structures, indicates that the Winter Report's recommendations would, in fact, affect a nontrivial number of firms.⁵ Even a small slice of the European Union's eight trillion dollar economy is surely worthy of sustained attention.

But there are perhaps even more compelling, if less straightforward, reasons why this is a timely and important topic. Part II will discuss the interaction between so-called "technical barriers," the focus of the Winter Report's analysis, and "structural barriers" to takeovers. "Technical barriers" can have an effect on "structural barriers." Part III will then consider some possible lessons the British and American experience with takeover regulation hold for why European takeover law matters despite its ownership structure and how European takeover regulation might profitably proceed. These discussions will provide a good vehicle for raising some of the issues that need to be addressed in evaluating the merits of the Winter Report's recommendations on takeover regulation.

II. INTERACTION BETWEEN TECHNICAL AND STRUCTURAL BARRIERS TO TAKEOVERS

The Winter Report goes out of its way to make clear that it does not take a position on either the general desirability of concentrated ownership nor the need for "harmonizing" ownership structures in the European Union. But avoiding these topics entirely is not possible. The presence (or lack) of a market for corporate control of companies with dispersed ownership could have an effect on whether a concentrated

³ Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, European Commission, Brussels, Jan 10, 2002 (hereinafter Winter Report). There was a second report issued on company law generally in November of 2002. See Report of the High Level Group of Company Experts on a Modern Regulatory Framework for Company Law in Europe, Nov. 4, 2002.

⁴ At this point in time it looks as if the proposed "break-through rule" will not be pursued by the European Commission.

⁵ See Morten Bennesen and Kaspar Nielsen, *The Impact of a Break-Through Rule on European Firms*, Working Paper (2003).

ownership structure for some European firms will continue to persist. In other words, the interaction between “technical barriers” to takeovers (such as the use of defensive tactics by target management) and “structural barriers” (such as concentrated ownership) must be considered in an overall analysis of the Report’s recommendations.⁶

Unfortunately, the sign of this interaction effect is theoretically unclear. “Technical barriers” might either encourage continued concentrated ownership or promote dispersed ownership. Consider the first possibility. High, systematic levels of concentrated ownership is often attributed, at least in part, to poor corporate law which enables controllers to enjoy private benefits of control, often at the expense of minority shareholders.⁷ If there are significant private benefits of control for controllers and an active market for corporate control in companies with dispersed ownership, then this could make it *less* likely that companies with a controlling share block will adopt a dispersed ownership structure via the controller selling his control block.⁸ There is the possibility that a third party will acquire control of the company with a dispersed ownership structure, given the existence of an active market for corporate control, and thereby acquire the private benefits of control for himself. This possibility would make it less likely that a controller will agree to a dispersed ownership structure in the first place if such a decision will merely result in an uncompensated transfer of the private benefits of control from himself to a third party.

There is another story, however, one could tell. Concentrated ownership might be the result of high managerial costs resulting from a dispersed ownership structure rather than high private benefits of control associated with control blocks (or perhaps a combination of the two).⁹ The high agency costs associated with the paradigmatic Berle and Means corporation might deter controllers from adopting such a structure in the first place. A market for corporate control, energized by a takeover-friendly regime, could

⁶ Cf. Ronald Gilson, *The Political Ecology of Takeovers in EUROPEAN TAKEOVERS* 49-75 (1992).

⁷ See generally R. La Porta, F. Lopez de Silanes, A. Shleifer, and R.W. Vishny, *Legal Determinants of External Finance*, 52 *J. Fin.* 1131 (1997); R. La Porta, F. Lopez de Silanes, A. Shleifer, and R.W. Vishny, *Investor Protection and Corporate Governance*, 58 *J. Fin. Econ.* 3 (2000). As the Winter Report properly emphasized, however, concentrated ownership should not be viewed as a problem *per se*.

⁸ See generally Lucian Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper 7203 (1999) (modeling this effect).

⁹ See Mark Roe, *Corporate Law’s Limits*, 31 *Journal of Legal Studies* 233 (2002) discussion of this point.

reduce these managerial costs and thereby render a dispersed ownership structure more attractive than it otherwise would be to a controller considering relinquishing control.

So which is it? The balance of the evidence indicates that a more robust takeover market would render dispersed ownership structures more, rather than less, attractive. It is true that there is strong empirical evidence that controllers in Continental Europe, on average, enjoy substantial private benefits of control. This empirical evidence consists of the premiums paid for control blocks and voting shares. These premiums are widely interpreted as proxying for the size of the private benefits of control. The premium paid for a control block in Italy, for example, is 25% to 30% of firm value. The premium on shares with voting rights (with the baseline being shares without voting rights) is some 28% in France.¹⁰ More generally, the size of the private benefits of control around the world do appear to be associated with ownership concentration.¹¹

However, it is unlikely that the Winter Report recommendations on takeovers would deter controllers (more than they currently already are) from adopting a dispersed ownership structure for fear of a new controller extracting private benefits of control. A centerpiece of the Winter Report's recommendations is the proposal that target management be barred from taking "actions frustrating a takeover bid" without shareholder approval.¹² It would obviously be in the interests of shareholders in a dispersed company to authorize management to block a bid by a party primarily interested in extracting private benefits of control. And it would be in the interests of target management to point this out if they wish to have the bid defeated.

The effects of the mandatory bid rule need to be addressed in assessing the probability that a new controller, rather than increasing firm value, would extract private benefits of control at the expense of minority shareholders. As is well known, a mandatory bid rule reduces the probability of a value-reducing takeover as an acquirer, once the mandatory bid rule is triggered, will be unable to benefit at the expense of non-controlling shareholders.

¹⁰ See Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 *J. Fin. Econ.* 325 (2003).

¹¹ See generally R. La Porta, F. Lopez de Silanes, A. Shleifer, and R.W. Vishny, *Legal Determinants of External Finance*, 52 *J. Fin.* 1131 (1997); R. La Porta, F. Lopez de Silanes, A. Shleifer, and R.W. Vishny, *Investor Protection and Corporate Governance*, 58 *J. Fin. Econ.* 3 (2000).

¹² See Winter Report, Recommendation 1.2.

All of this is to say that the Winter Report would be unlikely to deter the adoption of dispersed ownership structures. But would it encourage it through reducing managerial costs associated with dispersed ownership structures? The bulk of the evidence suggests that the threat of a hostile takeover does, in fact, operate to reduce managerial costs and thereby increase the value of firms with dispersed ownership structures.¹³ For example, in a recent paper Gompers, Ishii and Metrick found that companies with more antitakeover protections had a lower Tobin's Q (one commonly used measure of firm valuation) throughout the 1990s.¹⁴ Moreover, they found that antitakeover protection was associated with poorer firm performance in terms of their return on equity and sales growth. Studies measuring market reactions to the adoption of various state antitakeover statutes have documented significant, negative market reactions.¹⁵ Consistent with these studies are the findings by Bertrand and Mullinathan that more antitakeover protection is associated with weakened managerial incentives to minimize labor costs.¹⁶

But this evidence also suggests the possibility that a mandatory bid rule has a serious downside if it increases the cost of takeovers, perhaps through increasing financing costs and increasing bidders' exposure to idiosyncratic firm risk, and thereby reduces their probability. There is a further cost if the mandatory bid rule is applied to firms with concentrated ownership as this might reduce sales of control blocks and thereby "lock in" the current controller even if another controller would be able to add value. This is potentially a quite serious cost.

It is necessary to weigh this cost against the benefit of a mandatory rule in forcing potential controllers to internalize the costs of any private benefits of control they may wish to enjoy upon achieving control and, hence, make it more likely that a controller will be willing to move to a dispersed ownership structure in the first place. The importance of this benefit will be different for different countries. While private benefits of control do appear to be, on average, quite substantial in Continental Europe, there is

¹³ I am using a very broad notion of "managerial costs" covering a wide range of managerial conduct.

¹⁴ See Paul Gompers, Joy Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, 118 *Quarterly Journal of Economics* 107 (2003).

¹⁵ See, e.g., Mick Swartz, *The Massachusetts Classified Board Law*, 22 *J Econ & Fin* 29 (1998).

¹⁶ See Marianna Bertrand & Sendhil Mullinathan, *Executive Compensation and Incentives: The Impact of Takeover Legislation*, NBER Working Paper 6830 (1998).

significant variation across countries. For instance, the voting premium on shares with voting rights in Denmark is 1%, which is actually lower than that of the United States.¹⁷ In the U.S. there is some empirical evidence suggesting that most block trades are not motivated by bidders wishing to extract large benefits of control.¹⁸ However, in countries with high levels of private benefits of control, unlike Denmark and the U.S., the mandatory bid rule might play an important role in protecting shareholders in a takeover situation. Given the enormous variation in the private benefits of control, the trade-off in terms of what a mandatory bid rule should look like might very well vary as well. A one-size fits all approach, mandated at the European Union level, may therefore be inappropriate.

One final suggestive piece of evidence on the effects of having a market for corporate control on ownership structure is some recent research indicating that acquisition and merger activity in the United Kingdom was the primary mechanism by which ownership became dispersed.¹⁹ Might the pattern of acquisition and merger activity in Continental Europe account for the different ownership structures? And would changing the pattern and incidence of acquisition and merger activity – via a more robust market for corporate control in dispersed corporations – affect ownership patterns in Continental Europe? There is still much research that needs to be done on the interaction between acquisition and merger activity and the mechanisms driving shareholder dispersion.

III. STANDING THE TEST OF TIME? TWO CASE STUDIES

Putting aside the interaction between “technical” and “structural” barriers to takeovers, there is another important reason for why one should be interested in Continental European takeover regulation at this particular point in time. It is precisely when the number of companies potentially “threatened” by a hostile takeover is relatively

¹⁷ See Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 *J. Fin. Econ.* 325 (2003).

¹⁸ See Erik Berglof and Mike Burkart, *European Takeover Regulation*, 36 *Economy Policy* at 196-198 (April 2003) (discussing the empirical evidence on this point).

¹⁹ See Franks, Mayer & Rossi, *The Origination and Evolution of Ownership and Control*, Working Paper (2002).

small that regulators have somewhat more leeway in the type of legal regime they can realistically consider. A takeover regime, for instance, that limits managers' ability to impede unwelcomed takeovers, as is proposed in the Winter Report, might well prove politically impossible to enact in a situation where management across the corporate universe view themselves as potentially on the receiving end of a hostile takeover bid.

Of course, regulatory regimes can change over time in response to new pressures. All of this leads to the following question: Which regulatory approaches have stood the test of time? And what lessons might they hold for Continental European takeover regulation? I will begin with a discussion of the U.S. and British experience with takeover regulation and then will draw some tentative lessons these experiences may hold for the European Union.

The United States

The takeover regime in the United States is an example of a regime that has not clearly addressed the legality of most takeover defenses (including, crucially, the "poison pill" defense in the presence of a staggered board of directors) until relatively late in the game.²⁰ Indeed, some have suggested that it was not until the Delaware Supreme Court's 1995 opinion in *Unitrin v. American General Corporation* that it became reasonably clear that corporate management has the right to maintain, with very little in the way of justification, a takeover defense against an unwanted takeover bid without the need to obtain shareholder approval. In *Unitrin* itself, target management's justification for not bringing the bid before the shareholders for consideration was the *claim* that shareholders, given their possible ignorance and confusion, were incapable of assessing the merits of the bid.²¹ The Delaware Supreme Court found this justification to be a

²⁰ That is not to say that there were not takeover cases prior to the 1990s that provided some guidance. There obviously were. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964). But there was substantial uncertainty about the limitations these cases placed on the use of defensive tactics. See Ronald Gilson and Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is there Substance to Proportionality Review?*, 44 *Bus. Law.* 247 (1989) (describing this uncertainty).

²¹ The *Unitrin* Board was concerned that "Unitrin's shareholders might accept American General's inadequate Offer because of ignorance or mistaken belief regarding the Board's assessment of the long-term value of Unitrin's stock." 651 A.2d 1384 (Del 1995).

legally sufficient basis for target management's use of a defensive recapitalization to block the bid.

It is hard to see how this is a justification given the fact that management can always claim that shareholders are confused and ignorant. The sweeping nature of the *Unitrin* justification is troubling. As Vice Chancellor Strine of the Delaware Chancery Court put it, "If stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time for deliberation has been afforded them?"²² One would like to see at least some evidentiary basis before such a presumption were made.

Regardless of whether the *Unitrin* case of 1995, or some point a few years earlier, is the exact date that the broad permissibility of defensive tactics became clear,²³ the important point is that corporate law in the United States only addressed this issue long after hostile takeovers had first appeared on the scene in a major way. Indeed, and not coincidentally, the 1980s saw the hostile takeover being commonly used by bidders interested in breaking up and streamlining companies. In those acquisitions, target management often lost not only their private benefits of control associated with running the target company but their jobs as well. In reaction to the 1980s boom in the use of the hostile takeover, corporate management (along with other groups) placed enormous pressure on states – regulators and legislators alike – to legitimize the use of defensive tactics regardless of shareholders' views.

While the question of how much discretion states would provide target management in the use of the "poison pill" defense was left unresolved in the 1980s, states did adopt a series of antitakeover statutes throughout the 1980s providing target management with more leeway in preventing and blocking unwanted bids. Once the constitutionality of the first wave of state antitakeover statutes were called into question in the early 1980s in *Edgar v. Mite*,²⁴ states substituted these constitutionally suspect laws with a new set of antitakeover statutes.

²² *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000).

²³ Other academics, myself included, read the Delaware Supreme Court's 1989 opinion in *Paramount Communications, Inc. v. Time*, 571 A2d 1140 (Del 1989) as the moment when it became reasonably clear that target management has broad authorization to use defensive tactics.

²⁴ 457 U.S. 624 (1981).

The fact that a group disadvantaged by a particular practice would seek regulatory and legislative protection from that practice is neither surprising nor grounds for criticizing U.S. corporate law. Such is life. But what made corporate management's views on this matter particularly influential is the ability of corporations to select, through their (re)incorporation decision, which state's corporate law – including takeover law – will govern the corporation. More specifically, corporate management, under the law of every U.S. state, has a veto over whether reincorporation to another state will occur. States such as Delaware which care about maintaining (or increasing) their stock of incorporations will therefore give substantial weight to managerial interests. In other words, corporate management, in addition to whatever lobbying effort it undertook, was given leverage by the very regulatory structure of corporate law in the United States.

The end result of this process has been state takeover law that has placed relatively few discernable limits – as the *Paramount v. Time* and *Unitrin* cases illustrate – on the use of takeover defenses in the typical hostile takeover context.²⁵ The takeover defense that is the most potent, and therefore the most troubling, is the use of the “poison pill” defense in conjunction with a staggered board. With a “poison pill” in place, a bidder cannot acquire control of a target company without acquiring control of the target board first. And with a staggered board in place, a bidder cannot acquire control of the target board, given the staggered terms of directors, unless the bidder is willing to wait several years. The number of hostile takeovers in the 1990s, compared to the rate in the 1980s, dropped by approximately two-thirds. Tellingly, it was in the 1990s that it became clear that the “poison pill” defense would be permitted in a wide range of circumstances. Moreover, and equally telling, those companies that did not have a staggered board were unable to convince shareholders in the 1990s to adopt one. Most firms eventually gave up even trying.

This pessimistic interpretation of U.S. takeover law is not universally shared by legal academics or practitioners. One common defense is the observation that the explosion in stock option incentive compensation in the 1990s has made target

²⁵ Few discernable limits does not mean none. The Delaware courts have, to their credit, prohibited the use of so-called “dead-hand poison pills.” See *Camody v. Toll Brothers*, 723 A.2d 1180 (1998). Moreover, when management puts a company up for sale, this will trigger heightened fiduciary duties to shareholders. *Revlon*, 506 A.2d 173 (1985).

management more likely to agree to a bidder's offer in the first place as stock options typically vest upon completion of a merger.²⁶ A value-maximizing Coasian bargain can now be struck whereby target management enjoys vested stock options, the bidder acquires the target, and target shareholders receive whatever market premium is being offered by the bidder. The empirical support for this claim, at least at this date, is lacking.²⁷

It would be an overstatement to claim that there are no mitigating factors. The weakness of U.S. takeover law is offset somewhat by the fact that it is a commonly held view in the United States that the corporation should be run, at least ordinarily, in the interests of shareholders. The prevalence of this belief does make it more difficult, as a practical matter, for corporate management to block hostile takeovers regardless of shareholders' interests. Cultural norms and widely held attitudes can matter.

The United Kingdom

The United Kingdom's takeover regime, on the other hand, is an example of a regime that has taken – from an early point in the history of hostile takeovers – a clear position on the use of takeover defenses that is much superior to the U.S. position.

Prior to World War II, merger and acquisition activity in Great Britain consisted of a bidder convincing the target's board of directors to sell their personal shares to the bidder. Target directors would then inform shareholders that they had sold their shares and that they recommended that shareholders follow suit. The bidder would then typically purchase shares from tendering shareholders on the same terms offered directors.²⁸ In short, takeovers were negotiated deals involving target management. Shareholders were encouraged to follow the lead of management.

It was only in the 1950s that hostile takeovers appeared on the scene as result of entrepreneurs like Sigmund Warburg and Charles Clore. Shortly after they gained

²⁶ See, e.g., Marcel Kahan & Ed Rock, How I learned to stop worrying and love the pill, 69 U.Chicago L.Rev. 871 (2002).

²⁷ See generally John C. Coates IV and Reinier Kraakman, CEO Incentives and Merger Activity in the 1990s: Stock Options and Real Options, Working Paper (2003).

²⁸ See Franks, Mayer & Rossi, The Origination and Evolution of Ownership and Control, Working Paper, Working Paper (2002).

notoriety with their use of hostile takeovers, the “Notes of Amalgamations of British Business” was introduced in 1959 outlining the basic principles that were to govern takeover bids. Nine years later, in 1968, the first version of the City Code on Takeovers and Mergers was published. Right from the start the City Code contained General Principle 7 which bars target companies, once a bona fide offer has been made or is imminent, from taking action which would “frustrate[]” the bid without first receiving shareholder authorization. This principle has remained a centerpiece of the City Code since that time. It has always been understood as seriously limiting the ability of target management to block unwelcomed bids.²⁹

And what of defenses adopted in the pre-bid period? There are a number of relevant statutory and London Stock Exchange rules that impede the adoption of certain types of defensive tactics. In addition to these provisions, there is a common law doctrine that managers may only use their corporate powers for “proper purposes.” In the groundbreaking case of *Hogg v. Cramphorn* it was concluded that placing a large block of stock in a trust fund established for the benefit of corporate employees was found to constitute an improper purpose under English common law given that the purpose of the managers in placing the shares was to block potential bidders.³⁰ As far as I am aware, the “poison pill” has never been used in the United Kingdom. It would very difficult to articulate a purpose behind the “poison pill” that did not consist of impeding or blocking unwanted bids.³¹

What accounts for the strong, persistent pro-shareholder position taken by British law in the takeover context? One factor might be that, unlike in the United States, a clear position on the role of shareholders in the context of a hostile bid was taken early on. Hostile takeovers first arrived on the scene in the 1950s. By the end of the 1950s, there was already a preliminary regulatory framework in place. By 1968 the City Code was

²⁹ One commentator has summarized General Principle 7 as basically limiting the defensive tactics of management to “providing information to the shareholders . . . , appealing to shareholder loyalty or patriotism, using their own and their supporters’ resources to buy target company shares in the market . . . , and lobbying the government to have the bid referred to the Monopolies and Mergers Commission.” Paul Davies, *The Regulation of Defensive Tactics in the United Kingdom and the United States*, in *EUROPEAN TAKEOVERS* at 200 (1992).

³⁰ See 254, [1966] 3 AER 420 Ch. 254.

³¹ See Paul Davies, *The Regulation of Defensive Tactics in the United Kingdom and the United States*, in *EUROPEAN TAKEOVERS* at 210 (1992).

firmly in place. Taking a sound position early on had two possible benefits. First, corporate managers did not see hostile takeovers as much of a threat as they later on might have given their frequency at the time. This provided regulators with some space, in contrast to the situation in the United States, in crafting a regulatory regime. Secondly, once a regulatory position was adopted a certain degree of inertia inevitably set in. It is harder to change a regulation, generally speaking, than it is to enact one.

But surely inertia is not the entire explanation. How was it that the City Code, throughout all its revisions over the years, managed to retain General Principle 7 and its overall focus on shareholder empowerment? A partial answer might lay in the composition of the Takeover Panel, which is responsible for administering the City Code. The Takeover Panel is a self-regulatory body whose decisions, despite its traditional quasi-governmental status, have virtually never been ignored.

The membership of the Takeover Panel is diverse, representing the interests of a number of different participants in the capital markets. This membership includes institutions representative of investors such as pensions funds and investments trusts. Members also include industry participants such as the British Merchant Banking and Securities House Association, the Stock Exchange, the London Investment Banking Association and the Institute of Chartered Accountants. In addition, companies themselves are represented by the Confederation of British Industry. Moreover, the Takeover Panel throughout its history has worked closely with the Bank of England.

The composition of the Takeover Panel, and its relationship with the Bank of England, ensures that the interests of all capital market participants are represented including investors as well as corporate managers. Any proposed change to takeover regulation, such as General Principle 7, would likely fail without first obtaining broad consensus across these different constituencies. Since the promulgation of the City Code in the 1960s, many commentators have noted that a strong culture has developed in the City Code emphasizing the important role played by shareholders in the running of the corporation, including their right to assess for themselves the merits of a bid. Indeed, the Confederation of British Industry has objected to proposals at the European Union level authorizing the use of defensive tactics as undermining the proper role of shareholders.

Lessons

So what lessons do these two (brief) case studies hold for how to approach the regulation of takeovers in Europe? I will draw attention to three tentative lessons that can be drawn from the British and American experience in takeover regulation that are worth considering when evaluating the Winter Report's recommendations.

1. The Desirability of Addressing Takeover Regulation Early

One way in which the United States and United Kingdom differ is when they addressed the legality of various defensive tactics. The United Kingdom addressed this issue far earlier than the United States and since that time has had a widely admired takeover regime. Simple political economy considerations suggest that the two are not entirely independent. The earlier a takeover regime is erected the more leeway regulators have, all else being equal, in considering different possible approaches.

Timing might be especially important for Continental Europe where labor is particularly powerful politically.³² If there is a hostile takeover that is widely perceived as resulting in layoffs (whether true or not) then this runs the risk of increasing the political pressure to adopt a takeover-hostile regime. The negative political reaction in many quarters to the hostile takeover by Vodafone of Mannesmann and the failure of the Thirteenth Directive is cause for concern on this score. Of course, there are no guarantees. If the political pressures are sufficiently strong, then a takeover-friendly regime, regardless of when it is adopted, will be unlikely to survive.

It might be helpful, in this regard, to emphasize that protection of various "stakeholders" in the corporation, such as employees, is an analytically separate question from whether a mandatory bid rule, a break-through rule, or a ban on the use of defensive tactics is good policy. Stakeholder protection, assuming that is one's goal, can be addressed separately from takeover regulation. Employee protection need not imply providing management with the means to block unwanted takeovers.

³² I would like to thank Mark Roe for pointing this out.

2. *Participation in the Regulatory Process*

Another lesson that can be drawn from the American and British experience is the importance of which market participants are given a voice in the regulatory process. The structure of regulatory competition in the U.S. has resulted in managers having a great deal of influence over the corporate law that governs their firm. The regulatory process in the United Kingdom, in contrast, ensures that investors and other market participants, in addition to corporate management, play an important ongoing role.

Naturally there are many ways that shareholders can be given a voice in the regulatory process. The United Kingdom's self-regulatory model is only one. Lucian Bebchuk and I have proposed for the United States a regime of regulatory competition in corporate law – but one that empowers shareholders to make reincorporation decisions not subject to a managerial veto.³³ We labeled this “choice-enhancing” competition. Criticism of U.S. takeover regulation need not imply a distrust for competition. Indeed, a “choice-enhancing” approach emphasizes the need for a diversity of approaches that cover the spectrum of shareholder needs and preferences in a variety of settings.

In contrast, the Winter Report states that shareholders should not be permitted to make a decision, prior to a bid occurring, on whether to provide management with the authorization to use defensive tactics. Shareholders' decisions must be made *ex post*; after a bid has been made. This is perhaps the most troubling aspect of the Winter Report's recommendations. This limitation of shareholder choice is in tension with shareholder decision-making, the first guiding principle of the Report. Why shouldn't shareholders be able to make a decision *ex ante*? Under the “choice-enhancing” proposal, shareholders could, if they wanted to, elect a regime where it is settled that takeover defenses are unavailable to target management before a bidder ever arrives on the scene.

Under a range of circumstances, it is plausible that shareholders will conclude that the optimal arrangement entails some element of *ex ante* commitment on their part. It might be that shareholders *ex post* will find it in their interests to authorize the use of defensive tactics so as to enable management to extract a higher takeover premium from

³³ Lucian Bebchuk and Allen Ferrell, A New Approach to Regulatory Competition, 87 Virginia Law Review (2001).

the bidder. But this might not be the optimal regime *ex ante* given the lower probability of a bid in the first place. Of course, this does not mean that what shareholders will decide to do *ex ante* is obvious. There is an extensive debate and discussion in the American legal academic literature over exactly when shareholders might find it in their interest to commit to a position on defensive tactics in the pre-bid period.

The only explanation the Winter Report provides for limiting shareholder choice to the post-bid period is the belief that shareholders will be better informed once they can assess the merits of a particular bid. But shareholders will know this when they are deciding whether to authorize management to use defensive tactics in the pre-bid period. And if shareholders are too confused or disinterested to make this calculation, then why assume that shareholders are sufficiently competent to make decisions on defensive tactics in the post-bid period? Surely an across-the-board assumption of shareholder incompetence in the pre-bid period is too sweeping.

3. The Importance of Substitutes

A third lesson that can be drawn from the American and British experience is the importance of considering substitutes when regulating. For example, if one is concerned about the use of takeover defenses, it is unprofitable to focus on only one particular type of defensive tactic. When the first generation of state antitakeover statutes ran into constitutional difficulty in the United States, states just substituted those statutes with a new set of statutes.

In contrast, the City Code in addressing the issue of defensive tactics has taken a broad principle-based approach prohibiting the use of takeover defenses once a bid has been made regardless of the particular form of the takeover defense. Throughout the City Code's existence, the Takeover Panel has not hesitated in ruling that new types of takeover defenses are impermissible. While there are specific prohibitions in the City Code on the use of certain defensive tactics,³⁴ this does not mean that defensive tactics not on the list are off the hook. For example, the use of litigation by a target as a

³⁴ See Rules 21 and 37.3.

delaying tactic, commonly used in the United States, is subject to General Principle 7 despite not being listed in any specific Rule.³⁵

Has the Winter Report cast its net wide enough to avoid the danger that the use of substitutes will undermine its regulatory goals? The break-through rule applies to dual class shares but not to pyramid schemes. As other commentators have pointed out, the two are substitutes in that they both separate voting and cash flow rights.³⁶ It is possible that if the Winter Report's recommendations are implemented, firms will merely switch from using dual class shares to pyramid schemes in order to separate ownership from control. If substitution does occur, it is unclear what would have been accomplished. The Report cannot be blamed for not addressing this issue given its mandate but it does highlight the importance of considering substitutes.

IV. CONCLUSION

In assessing the Winter Report, a variety of issues need to be considered. One such issue is the implications that takeover regulation has for ownership structures. In general, a takeover-friendly market for corporate control will likely make dispersed ownership structures more attractive on the margin. The bulk of the empirical evidence suggests that takeovers play a useful role in allocating assets and disciplining management of companies with dispersed ownership. Takeovers are likely to be especially important for the economy of the European Union given the recent emergence of a common market and the implications this has for the optimal structure and organization of firms.

In thinking through how (and when) one should proceed when crafting a takeover regime, it is helpful to look to the U.S. and British experience in regulating takeovers. This experience holds three tentative lessons: (1) the importance of timing when making the hard choices involved in crafting a takeover regime; (2) the importance of who has influence over the regulatory process as it evolves over time; and (3) the need to consider substitutes when considering the impact of a particular regulation or legal rule.

³⁵ *Consolidated Gold Fields* (Takeover Panel, May 9, 1989) at 4.

³⁶ See, e.g., Lucian Bebchuk and Oliver Hart, A Threat to Dual-Class Shares, *Financial Times*, May 31, 2002.