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Takeover Bids:
A Comparative Analysis of the
EU and US Approaches**

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Summary

Global Merger and Acquisition activity reached record levels in 2006, with the US and EU playing a large role in this activity. This paper examines the duties of a board which is subject to a takeover bid and any defensive moves the board may take to protect its company from acquisition.

The US law in this field requires the boards to actively participate in any bid offers and grants these boards the option to veto a bid or send it to shareholder for approval. These active boards may take a number of actions in order to promote or prevent the bid, so long as these actions were informed business decisions meant to help the company and maximize shareholder value. There are a number of clauses that may be inserted into a bid to give the offeror a better chance of the targets acceptance and these are legal in the US to the extent that they do not lock the target company into a deal that cannot be avoided if there is a change of circumstances. Additionally, US target boards may enact devices to make their companies less attractive to a bidder in order to prevent takeover. These defensive techniques are legal as long as they are made for a business reason and not a personal decision by the directors to entrench themselves on the board.

European boards are more passive in the face of a takeover offer than their American counterparts and rely more on shareholder approval. The Thirteenth Company Directive was approved in 2004 and places the obligations of neutrality on EU boards in a takeover bid. This directive also includes a number of other clauses to promote takeovers, including a breakthrough rule designed to neutralize defensive measures. In light of the Directive, German and UK and updated their laws and take differing approaches to takeovers. The passivity of EU boards and their inability to veto bids prevents many bid protection devices. EU boards cannot take actions to frustrate a takeover bid without shareholder approval to do so, thereby limiting their use in the EU.

Both approaches have their supporters and critics, and it is unclear which approach is better for the shareholders as a whole but each approach offers unique rules for the target boards to follow.

Abbreviations

EU	European Union
UK	United Kingdom
US	United States
USD	United States Dollars
MS the Directive	Member States Thirteenth Directive of the European Union on Takeover Regulation

1 Introduction

In 2006, completed corporate takeover transactions amounted to a value of approximately 3.8 trillion USD, the highest annual volume for takeover transactions ever.¹ After the passage and required 2006 implementation of the EU Thirteenth Company Directive on Takeovers, transactions within the EU accounted for approximately 1.6 trillion USD, up 46% from the previous year.² Leading the way in Europe was the UK, with 369 billion USD of transactions, and Germany, with the EU's largest transaction of the year valued at 65.5 billion USD.³ These figures show the global, and especially EU, market for corporate takeovers remains very active and continues to grow with the implementation of the Directive.

US takeover law resides mostly in state laws as a result of a "race to the bottom" in the state of Delaware which is the state of incorporation of the majority of US corporations. Delaware law is very developed in this field and sets the standards for most other states when implementing their own takeover laws. However, the active participation of US boards in takeovers, coupled with ambitious bidders, continues to invent new techniques for boards to protect their shareholders interests and for bidders to obtain deal protection and beneficial terms for their takeover offers.

The Directive is a controversial measure seeking to harmonize EU takeover law while allowing individual MS to maintain a degree of their separate legal identities. Looking at the MS' it becomes apparent that the UK and Germany represent two of the most active MS in takeovers while situated at opposite ends of the spectrum of national takeover law within the EU. The UK environment is closer to the US model allowing bidders and boards more options in takeover negotiations, while German law appears more protective of its companies and labour interests. Despite their differences, there are many similarities in the laws implementing the Directive in these countries, including the concept of board neutrality, which is as foreign to the US as Europe itself.

1.1 Purpose

The US and EU have emerged as two active takeover markets and the business, cultural and legal similarities make it logical for companies on each side of the Atlantic to explore takeover opportunities in the other market. To fully understand the feasibility of a transaction in a foreign jurisdiction one must first become informed of the legal issues surrounding an offer and acceptance in this new jurisdiction. The aim of this paper is to

¹ Gordon, P., *Merger Boom Likely to Continue in 2007 Despite Increased Scrutiny of Cross Boarder-Deals*, Global Finance 21, 2 ABI Inform Global (February 2007).

² Id.

³ Id.

explore what is the role of a target board in the event of a takeover bid as well as the options available to the board and the shareholders to protect or repel the bid based on the requirements of the company. Furthermore, this paper will discuss the differences between the EU and US laws in this field and the limitations as well as the benefits of each approach.

1.2 Methods and Materials

In pursuing the goal of evaluating the role of a target board and the laws in which it must follow, this paper uses a variety of methods to provide the reader with an accurate and up to date analysis of the situation. The US analysis is conducted in a traditional legal manner, looking at statutes, case law, and secondary legal sources for guidance on the legal implications of the issues discussed herein.

The EU laws in this field are rapidly evolving with the long awaited approval of the Thirteenth Company Directive and its required transposition deadline less than a year before this paper. The relative newness of this legislation, and the resulting MS implementing legislation, make it important to look more to secondary sources to determine the effects of the Directive because case law has not yet emerged in this area.

Beyond the legal analysis, there is a business aspect to this topic, which is discussed to a limited extent. This paper uses an interview with a private equity industry expert as well as business orientated studies and articles to explain the financial and managerial implications of the measures and requirements discussed in this paper.

1.3 Delimitations

In order to conduct a proper analysis of this subject it is important to use the most up to date materials as well as a historical prospective to explain how the laws grew to what they are now. Because of the subject matter consisting of the US, EU, German and UK legal and economic situations for a variety of board related issues, this paper is limited in the depth of its analysis in certain topics, and omits others, in an attempt to give a reader insight into as many intertwined topics as possible.

The recent implementation of the Directive made it especially difficult to find case law or opinions related to many of the topics of this paper. In order to achieve the most current analysis possible, secondary legal sources are used for guidance on the probable implications of new legislation resulting from the Directives implementation.

Any analysis of the situation in the EU requires examining at least two of the twenty-seven differing approaches by MS in order to show the different situations that may arise within the internal European market. This approach leads to the examination of two MS with different rules in the

relevant areas but also highlights the problems which may arise due to language barriers. The UK and Germany are the MS discussed because of their differing approaches to this field. Obtaining an English version of the German legislation implementing the Directive proved to be impossible, and this paper substitutes analysis by law firms and industry professionals for the legislation itself. While this method of analysis is not favourable, the benefits of examining two MS approaches to the issues outweigh the drawbacks encountered by not having the original legislation.

The US perspective of this paper comes solely from Federal law and that of the State of Delaware, which is the place of incorporation for the majority of US corporations. Because of its position as the leading state in this field, Delaware sets the precedents that are emulated by many other US states, which unquestionably makes it the most important state to examine for this paper. Other state laws, which deviate from the Delaware approach, are minor in relation to the importance of Delaware law, however, it is important to note that references in to US law herein relate to Delaware law and the laws of other states may vary.

1.4 Disposition

Chapter 2 provides definitions of certain terms used throughout the paper as well as a brief look at the takeover environment in the relevant jurisdictions at this time.

The chapter begins with definitions of terms related to, and including, takeover bids. It further describes the reasons and benefits stemming from corporate takeover transactions. Finally, this chapter presents a short historical look at corporate takeovers in the US and the EU, ending with a description of the present environment.

Chapter 3 explains the duties of boards in the event of a takeover bid and the options available to them as a reaction to any offers. This chapter provides an introduction to the legislative measure of the relevant countries and a discussion on how these measures relate to a boards ability to react to bids, both friendly and hostile.

Chapter 4 focuses on the defensive measures available to corporations that find bids to be inadequate or unacceptable. This chapter briefly examines a few of the more popular measures available in the large US defensive arsenal and explains the EU evaluation of these measures.

Chapter 5 contains an analysis of the differing EU and US approaches to the boards actions in the event of a takeover bid, highlighting some important fundamental differences between the two markets.

Finally, *chapter 6* presents commentary on topics discussed in this study. Corporate Takeovers

1.5 Definitions

The definition of a corporate takeover is a public offer made to the securities holders of a company with the aim to acquire these securities as a means to acquire control of the company as a whole.⁴ It is important to note the difference between friendly and hostile takeover offers as the bidding procedures will be different based on the type of offer made, however the duties and options available to the Boards in the face of each type of offer remains the same. A friendly takeover is one that is approved by the target board of directors while a hostile takeover is one that is resisted by the target board.⁵ Corporate takeovers are often completed through tender offers, which are public offers to buy an amount of shares from the shareholders, usually at a premium price, in an effort to take control of the corporation.⁶

Takeover defences are measures taken by a corporation to discourage hostile takeover attempts,⁷ and may be pre-bid or post-bid. Pre-bid defences are barriers to the acquisition of shares of a company or to the exercise of control in the general shareholders meetings.⁸ These restrictions work to prevent the transfer of shares, set up voting agreements or create shares with multiple votes, creating a voting structure that bidders cannot overcome.

Alternatively, post-bid defences are reactions to unacceptable bids that work to thwart such bids by making the company less attractive to the bidder.⁹ Common post-bid defences include share buybacks by the company, the issuance of share capital, selling off parts of the company, or any other actions that will reduce the value of the company to the bidder.

1.6 Background

When a company is perceived by its competition, or any outside entity, to be undervalued or performing below its potential it becomes ripe for a takeover bid. In merger situations a company will look at a competitor's current profitability, expected profitability growth and the strategic impact of combining the business when evaluating the benefits of a takeover.¹⁰ If a bidding company believes that the potential benefits to the takeover outweigh the risk it may enter into takeover discussions with the target board or make an outright unexpected bid offer. After the initial offer the road to shareholder acceptance is "materially different between the EU and

⁴ Council Directive 2004/25/EC, Article 2 (2004).

⁵ Blacks law dictionary (8th ed. 2004)

⁶ Id.

⁷ Id.

⁸ Commission Working Document: *Report on the Implementation of the Directive on Takeover Bids*, SEC 2007 268, Pages 4-5 (February 21, 2007)

⁹ Id.

¹⁰ Interview with Joel Russ, Vice President, Audax Group (May 11, 2007).

the US”¹¹ but both end with the requirement of a shareholder vote to approve the transaction.

A successful merger results in one or more entities which should realize benefits of the merger.

”In the event of a completed merger the resulting entity may recognize gains in three main areas: i) revenue synergies; ii) cost synergies; and iii) value creation driven by increased strategic attractiveness. Revenue synergies might included product or geographic cross-selling or in pricing strategy. Cost synergies are often recognized in plant or facility consolidations and selling, general and administration reductions.

People will often pay a higher multiple of cash flow in businesses that are strategically more attractive.”¹²

Hostile takeovers made it into the European spotlight in 1987 with the acquisition of Societe Generale de Belgique by an Italian entrepreneur.¹³ After the major 1999 acquisition of Mannesmann by Vodafone, it became apparent that the EU required some harmonization to takeover law within its borders and the efforts to enact a directive on takeover bids were met with a sense of urgency.¹⁴ Even before a takeover directive was agreed upon, Germany, still feeling the effects of the Mannesmann takeover, enacted a national takeover regulation in order to set standards entities must follow in these transactions.¹⁵

After nearly 20 years negotiations and failed attempts, the European Commission finally passed a takeover directive on April 24, 2004.¹⁶ This directive on takeover bids contained numerous compromises, as a result of the years of failed negotiations, but was successful in introducing rules requiring corporate board neutrality in the event of a takeover bid and a breakthrough rule designed to neutralize certain takeover defences. Through national implementation of the Takeover Directive, MS’ move closer to the goal of harmonization of takeover laws to create level playing field for takeovers throughout the EU.

¹¹ Id.

¹² Id.

¹³ White, B., *Conflicts in the Regulation of Hostile Business Takeovers in the United States and European Union*, 9 IUS Gentium 161, 179. (2003)

¹⁴ Id. at 180

¹⁵ Id. at 185

¹⁶ Commission Working Document, *supra* n. 7, Page 3

2 The Role of Boards in Bids

Upon the receipt of takeover bid, the boards of target companies have varying duties depending on where the company is located. In the US Boards are the voice of the shareholders and actively participate in negotiations with the offeror, holding the power to frustrate an offer if they believe it to be in the best interest of the shareholders. EU laws are vastly different from the US when it comes to the roles of a board in a takeover bid, requiring varying degrees of passivity by the boards, which are not allowed to veto or frustrate a takeover offer without shareholder approval. Much like how US laws vary from state to state, EU laws vary from MS to MS but must comply with the Directive, which governs takeover bids within the EU. While the US Boards speak for and answer to the shareholders, the EU Boards have less control in a takeover situation, passing all the decision making in these situations to the shareholders.

2.1.1 US Legislation

US takeovers are subject to both federal and state laws enacted to protect shareholders and competition. Federal securities laws, enforced by the SEC work to regulate the securities instruments, which are the basis of publicly held company ownership. Securities themselves have no value, rather they represent a portion of ownership in the issuing company and their value fluctuates in correlation with the health of the issuing company. The purpose of securities laws is to regulate the issuance of these instruments and to ensure the accurate availability of information regarding the issuing company and its outstanding security instruments so that investors may be adequately informed about the business in which they have invested. These federal laws require public companies to, amongst other things, file registration statements containing facts and information about their business,¹⁷ continue to provide information about the company on a regular basis,¹⁸ and disclose certain transactions of the company.

The Williams Act took effect in 1968 and requires full disclosure of a party's ownership interest in a company it acquires significant portions of the company's stock. This act requires a party that acquires more than 5% ownership to disclose to the SEC, within ten days, their identity, the source of their funding, the amount of shares they hold in this company, the purpose of their acquisition and any arrangements they may have with others regarding this acquisition.¹⁹

In addition to Federal laws, each state has the power to regulate the companies incorporated within its borders. Under US law, companies can incorporate in any state, regardless of their principal place of business,

¹⁷ Securities Act of 1933, 15 U.S.C. § 77a (2007).

¹⁸ Securities Exchange Act of 1934, 15 U.S.C. § 78a (2007).

¹⁹ Williams Act, 15 U.S.C. § 78m (2007).

which allows them to forum shop for the most beneficial state for them to incorporate. Delaware laws contain tax incentives as well as highly developed corporate laws, which have created a race to the bottom leading to the majority of US companies incorporating in this state.

The result of these laws is that over 50% of US companies are incorporated within Delaware,²⁰ and its state corporate laws are the most developed in the nation, often providing models for other states when drafting and interpreting their own laws. Corporate takeovers in Delaware are governed by 8 Del. C. § 251 which sets the regulations for mergers and consolidations of corporations and limited liability companies registered in Delaware.

2.1.2 US Board Duties

The overriding duty of a US Board is usually to maximize shareholder value in the way that it feels is best, based on all the information available at the time. Delaware courts require the board to seek the best available reasonable price for the company, without considering any other non-monetary issues.²¹ While the requirement on the board is to get the highest price possible for the company there are certain requirements and duties with which the board must comply.

Traditionally, directors are protected by the business judgment rule, which shields their decisions from liability if the decisions can be traced to any rational business purpose.²² This rule creates the presumption that directors decisions were made on an informed basis, in good faith and with the actual belief that their decision is in the best interests of the company.²³ In order for a director benefit from the protection the business judgment rule they must uphold their fiduciary duties of care and loyalty and may be subject to a shareholder derivative lawsuit if they do not follow their duties.

The duty of care requires directors to be properly informed of all the information reasonably available to them before taking any action on behalf of the corporation. This calls for the directors to review the relevant materials before taking any corporate actions so that they may make their decisions with a reasonable amount of knowledge as to the expected results and alternatives that may stem from their decision. This information may come in the form of opinions, reports, committees, and other sources, including investment banker analysis of the financial implications of a takeover.²⁴ Under Delaware law, directors must act in a deliberate and informed manner before submitting a takeover proposal to the shareholders

²⁰ <http://corp.delaware.gov/>

²¹ *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

²² *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, at 720 (Del. 1971).

²³ *Brehm v. Eisner*, 746 A.2d 244, at 264 (Del. 2000).

²⁴ Block, D., *The Duties of a Target Company Under State Law: The Business Judgment Rule and Other Standards of Judicial Review*, 1528 PLI/Corp 7 (2006)

for approval so the shareholders receive properly informed recommendations before voting on a takeover approval.²⁵

Additionally, directors must maintain a duty of loyalty to the corporation in regards to all corporate transactions, including takeovers. The duty of loyalty requires that directors must act in good faith independent from their personal interest in the transaction.²⁶ A director cannot claim independence if they are a party to the transaction, have a relationship with a party to the transaction that may affect their judgment, have an interest in the transaction that may affect their judgment or may be influenced by a party that has an interest in the transaction.²⁷

These duties are requirements on the board constructed to ensure that directors live up to the shareholders requirements on them. So long as the directors uphold their fiduciary duties to the shareholders they will be protected from any decisions they make for the corporation, good or bad, no matter what the outcome. While these appear to be simple requirements for the board, in the complicated world of corporate takeovers such requirements can get overlooked very easily and often leave directors unsure of how to act in certain situations.

2.1.2.1 The Takeover Bid

When a takeover offer is made, the board must look at the offer and, in light of its duties mentioned above, determine if it will recommend shareholders to accept the bid or take defensive actions to prevent the takeover. A takeover offer is submitted to US Boards for their review and possible negotiations with the offeror, and it is only with the approval of the Board that the offer may be submitted to the shareholders for a vote.²⁸ US boards take a very active role in takeover negotiations as they are the voice of the shareholders as well as the advisors to the shareholders as they issue recommendations with any offers presented to the shareholders. Under Delaware law, when two corporations desire to merger they must adopt a resolution approving the merger, identifying the terms of the agreement and what structural changes will come from the merger.²⁹ Once the Board has approved the merger and created a merger agreement, the shareholders must vote at a annual or special meeting to approve the merger by a margin of the majority of the outstanding stock eligible to vote.³⁰ While the Board is not the sole decision maker on approving offers, it has a strong effect in the final outcome as many shareholders will vote based on the Boards recommendation. It is in bid negotiations and the actions the Board takes in

²⁵ *Smith v. Van Gorkom*, 488 A.2d 858, at 873 (Del. 1985).

²⁶ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

²⁷ Block, D., supra n. 24. quoting §1.23(a) of the A.L.I. Principles of Corporate Governance.

²⁸ Kraakman, R., Davies, inter alia, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Page 131, Oxford University Press (2004).

²⁹ 8 Del. C. § 251(b) (2007).

³⁰ 8 Del. C. § 251(c) (2007).

response to such bids where the directors must be especially vigilant of their duties to the shareholders. Because of the Boards ability to negotiate on behalf of the entire corporation it is easy for the directors to lose sight of the big picture and negotiate a deal that will benefit themselves, which is in violation of their duty of loyalty.³¹

The US system is set up so that there is joint decision making power between the Board and shareholders, with an emphasis on the Boards decision.³² This method of handling takeovers places an increased importance on the shareholders power of appointment because it is the directors whom they appoint which will be the voice of the entire company takeover negotiations.³³ Often the target Boards will call in investment banking or other finance specialists to determine the value of the company as a whole, or if it is dismantled and sold of in parts, so that they are sure to satisfy their duty of care by knowing the proper valuation of the company.

While the Board cannot accept the bid on its own it may veto any bid so that it does not make it to shareholders.³⁴ The Boards power, and responsibility, is magnified in situations where it vetoes a bid because of the spotlight placed on the Board duties to ensure that the veto was used for a valid purpose, in compliance with the requirements of the business judgment rule, rather than to ensure a favourable position for the directors.³⁵

Merger transactions are large-scale negotiations and the US grants the directors power to negotiate on behalf of the shareholders to obtain the best possible value for the company, which may include retaining control. As with any negotiations, it is allowed, and not uncommon, for a Board to reject the first bids so long as the rejection is made in good faith because the directors feel it is insufficient for the value of the company. Often a rejection is used as a bargaining tool with the expectation that the bidder will adjust its offer to something more agreeable to the directors of the target company.

2.1.2.2 Revlon Duties: Maximize Shareholder Return

Target companies are free to deny as many bids as they see fit, so long as they live up to their aforementioned duties, but once the decision has been made to sell a company the duty to obtain the highest price for the company. The Boards duty to maximize shareholder profit from a merger comes from the 1985 case of *Revlon Inc. v. MacAndres & Forbes, Inc.*, in which the Revlon Board denied hostile takeover bids until the offers got too high to for the Board to reject.³⁶ The Revlon court declared that once a transfer in

³¹ Kraakman, R., Davies, supra n. 28, page 164.

³² Id. at 168.

³³ Id.

³⁴ 8 Del.C. § 251(c) (2007).

³⁵ Kraakman, R., Davies, supra n. 28, page 171.

³⁶ *Revlon, Inc. v MacAndres & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985)

ownership becomes inevitable the Boards duty changes “from defenders of the corporate bastion to auctioneers charged with getting the best price for stockholders at a sale of the company.”³⁷ This case has become the cornerstone for dealings in all future merger transactions because of the fact that it clearly states the directors duty to maximize shareholder profits when it is clear that company will be sold.

While the Revlon requirements seem straightforward, a series of decisions involving Paramount Communications have clarified the situations in which a Board has the duty to maximize shareholder return. In the case of *Paramount Communications, Inc. v. Time, Inc.*, the court determined that the Revlon duty exists when a corporation actively initiates bidding and when it responds to a bidders offer by seeking a break-up of the company.³⁸ The second case is *Paramount Communications, Inc. v. QVC Network, Inc.*, in which the court reinforced that the Revlon duties exist whenever there is a transaction which will cause a change in control of the corporation or which will break-up the corporation.³⁹

2.1.2.2.1 Exceptions to the Revlon Duties

The Revlon line of cases sets out the requirements for when directors must seek the highest value for their companies, however there is a situation where an ownership transfer is possible without seeking the highest value. As stated in the QVC case, even if large percentages of stock are transferred to one owner there is “no sale or change of control when control of both companies remains in a large, fluid, changeable and changing market.”⁴⁰

The main way to complete a merger while avoiding the Revlon duties is in cases of a stock-for-stock merger, where one party acquires a large, but not controlling, share in the other company. This type of merger was the issue in the case of *In re Santa Fe Pacific Corp.*, where shareholders of Santa Fe brought action to prevent a merger which would result in another company owning 33% of Santa Fe.⁴¹ The Santa Fe shareholders contended that the directors violated their Revlon duty to seek the best value reasonably available to the company.⁴² The court held that the Revlon duty was not an issue in this case because it was largely a stock-for-stock merger in which Santa Fe’s Board never engaged in a transaction that would or did result in the change of control.⁴³ This court applied criteria from the QVC case in which states that there is no sale or change of control where under the

³⁷ Id. at 182.

³⁸ Block, D., supra n. 28, page. §II(C)2, quoting *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 at 1150 (Del. 1990).

³⁹ Block, D. supra n. 28, quoting §1.23(a) of the A.L.I. Principles of Corporate Governance and §II(C)2, quoting *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 at 48 (Del. 1994).

⁴⁰ *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 at 47 (Del. 1994).

⁴¹ *In re Santa Fe Pacific Corp.*, 669 A.2d 59 (Del. 1995).

⁴² Id. at 70-71.

⁴³ Id. at 71.

resulting ownership structure “control of a company remains in a large fluid, changing and changeable market” as is the situation here.⁴⁴

2.1.2.3 Unocal Defensive Actions Test

While the Revlon duties apply when a company is soliciting bids or sure to be sold, there are requirements on a Board in the event of taking defensive actions when facing hostile offers. These duties stem from the Unocal case which established a two-step test analysis which must be satisfied in order for the directors to receive the protection of the business judgment rule. Firstly, the Board must show that it reasonably believed that the takeover posed a danger to the corporate policy and effectiveness.⁴⁵ Additionally, the Board must show that the defensive measures enacted were reasonable reactions to the threat posed by the bidder.⁴⁶

2.1.2.4 Strengthening a Position: Bid Protection Mechanisms

Takeover bids in the US often contain terms limiting the actions of the target company while the bid is outstanding to improve the chances that the offeror in these deals will have their bid accepted, or reduce the chances of competing bids. Technically these bid protection mechanisms are defensive measures, however as their function is to increase the chances of a bid being accepted, they will be examined separately from the defensive measures designed to protect the target companies from hostile bids.

2.1.2.4.1 Window Shopping and No-Shop Clauses

No-shop clauses, as well as window shopping clauses, prevent target companies from soliciting additional bid offers after they have agreed to an offer containing these clauses.⁴⁷ Strict no-shop clauses have been struck down in court if a company has decided to change ownership, submitting the Board to the Revlon duties, and the provision prevents a board from carrying out its fiduciary duties, by restricting the directors from entering into discussions with third parties.⁴⁸ Where Revlon duties exist, a no-shop clause which restricts the Boards ability to accurately determine the value of the target company on the open market will be struck down.⁴⁹ No-shop provisions which act to prevent directors from considering unsolicited bids, which may maximize shareholder value, will be struck down by the courts.⁵⁰

⁴⁴ *In re Santa Fe Pacific Corp.*, 669 A.2d 59 at 71 (Del. 1995).

⁴⁵ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, at 955 (1985).

⁴⁶ *Id.* at 955.

⁴⁷ Block, D., *Public Company M&A: Recent Developments on Corporate Control, Protective Mechanisms and Other Deal Protection*, 1584 PLI/Corp. 7 at VII(B)(1). (Jan. 24, 2007).

⁴⁸ *Id.*

⁴⁹ *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 at 49 (Del. 1994).

⁵⁰ *Id.*, quoting *Revlon*, 506 A.2d at 184, *Macmillan*, 559 A.2d at 1287 and *Barkan*, 567 A.2d at 1288

There is, however, a situation in which no-shop clauses will be permitted by the courts, in situations where Revlon duties do not exist. Such conditions that allow no-shop provisions exist where the directors have already placed the company in an open auction, the agreement is a stock-for-stock transaction that does not change ownership or the Board is under the protection of the business judgment rule.⁵¹ The business judgment rule will protect Boards which have entered into No-Shops if they were “reasonably informed” of the value of the company when entering into the agreement.⁵²

Window shopping clauses are No-Shop clauses which provide the Boards with an out to ensure that they live up to their fiduciary duties, and are more widely accepted by courts.⁵³ By allowing Boards to provide unsolicited bidders with information about the company these companies may make bids that they feel are market value, thereby directors satisfy their fiduciary duties to be informed and get the best price for the shareholders.⁵⁴ This mechanism acts to protect bidders by preventing the target company from actively soliciting additional offers while protecting the Board by allowing it to provide information to interested bidders so that the all bids may be considered, thereby maximizing shareholder return by considering all offers.

2.1.2.4.2 No-Talk Clause

No-Talk clauses of bids prevent target corporations from soliciting or encouraging bid offers, as well as restrict the target company from providing third parties with information about outstanding bids and negotiating with these companies for competing bids.⁵⁵ The purpose of these clauses are to prevent target companies from driving up prices by using outstanding offers as a starting point in soliciting additional bids.⁵⁶ Courts often subject these clauses to excessive scrutiny as they aim to prevent a Board from meeting its duty to make an informed judgment by keeping it from even considering negotiations with third parties.⁵⁷

2.1.2.4.3 Break-Up and Termination Fees

Break-up fees, also known as Termination fees, are payments that must be made to the bidding party if there is an agreement and a triggering event, such as a refusal to accept the bid or the acceptance of a third party bid by the target company.⁵⁸ Break-up fees are not per se invalid, and actually common, so long as the board followed its fiduciary duties when entering into a deal with such a fee.⁵⁹ These fees create incentives for the target

⁵¹ Block, D., supra n. 47 at § VII(B)(1)(c).

⁵² *Paramount Communications Inc. v. Time Inc.*, 571 A.2d 1140, (1989).

⁵³ Block, D., supra n. 47 at § VII(B)(1)(a).

⁵⁴ Id.

⁵⁵ Id.

⁵⁶ Id.

⁵⁷ *Ace Ltd. v. Captial RE Corp.*, 747 A.2d 95, at 108-109 (1999), quoting *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, Del.Ch., C.A. No. 17398, tr. at 99-100 (1999).

⁵⁸ Herlihy, E., *Contests for Corporate Control 2007: Current Offensive & Defensive Strategies in M&A Transactions*, 1584 PLI/Corp. 7 at § VII(B)(1). (Jan. 24, 2007).

⁵⁹ *In re Toys “R” us, Inc.*, 877 A.2d. 975, at 1017 (Del. 2005).

company to uphold agreements they enter into with break-up clauses, or provide the bidding company with damages if the target company does not accept their deal. Such a clause works to protect a deal by creating an incentive for the deal to go through and may render superior bids ineffective if the increased value of the bid does not overcome the amount of the break-up fee. Courts will generally accept these break-up clauses so long as they are reasonable and while there is no set value that is acceptable the courts have suggested that break-up fees over 3% of the value of the deal will face increased scrutiny.⁶⁰

2.1.2.4.4 Matching Right

It is possible for bidding parties to draft their bid to include a matching, or topping, right which provides the bidding party with a period of time to match or exceed any superior offer made to the target company.⁶¹ This feature is permitted, and quite common, so long as the Board fulfils its fiduciary duties and obtains the maximum return for the shareholders.⁶² This mechanism is not particularly special because bidding parties always usually have the ability to counter competing bids. However, the main purpose of this mechanism is that it keeps the bidder in a transaction by preventing additional bidders from including mechanisms, such as lock-up clauses, which would foreclose the original bidder from making matching or topping the competing offer.

2.1.2.4.5 Lock-Up Clause

While US law related to deal protection mechanisms is fairly matured, the experts involved in the high stakes world of corporate takeovers will continue to find new ways to protect their deals and limit their risk. Recently, lock-up agreements have become a popular and controversial method of ensuring takeovers are approved and with this increased popularity comes increased scrutiny by the Delaware courts. A lock-up clause is a deal protection mechanism where the target board is bound to the agreement and cannot terminate it in favour of a better offer. This is often done when the offeror writes terms into the bid that guarantee it will reach shareholders and be accepted by a majority even in the event that the Board withdraws its support for that bid.

The courts view on these agreements was clarified in the 2002 Omnicare case.⁶³ In this case, NCS entered into a merger agreement with a company, Genesis, which, after significant negotiations, included a term guaranteeing a shareholder vote to be executed at the same time as a voting agreement where the two majority shareholders were bound to vote to approve the merger.⁶⁴ This became a problem when Omnicare subsequently made a superior offer which the Board could not put to the shareholders because of

⁶⁰ *In re Toys “R” us, Inc.*, 877 A.2d. 975, at 1016 (Del. 2005).

⁶¹ Block D., *supra* n. 47 at § VII(B)(5).

⁶² *In re Toys “R” us, Inc.*, *supra* n. 60, at 1016.

⁶³ *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2002).

⁶⁴ *Id.* at 925.

the agreements with Genesis did not allow NCS to escape the original agreement.⁶⁵ The court stated that the lock-up in question was reasonable under the first part of the Unocal test because at the time there was a real possibility of losing the offer from Genesis with no comparable offers available.⁶⁶ However, the agreement was not proportionate under the Unocal test because it was preclusive, preventing stockholders from receiving all offers, and coercive, forcing a management sponsored takeover upon the shareholders, which did not live up to the Unocal standards.⁶⁷ The agreement, as structured in this case, was invalid in the courts eyes because it lacked a fiduciary out clause, which would have allowed the Board to back out of the deal if it were in violation of the directors' fiduciary duties.⁶⁸ In quoting the Paramount case, the Court emphasized that agreements which limit or prevent the Board from its fiduciary duties are invalid, and that these fiduciary duties act as the sole protection for the minority shareholders and cannot be contracted away.⁶⁹ The lock-up in itself was not in violation of Delaware law, which specifically allows for provisions requiring shareholder votes and allows voting agreements,⁷⁰ but by forcing the Board to forgo its fiduciary duties owed to the shareholders it went too far.⁷¹ The Omnicare case is especially important not only because it stated the requirement of a fiduciary out clause in the lock-up agreements but also because it set the requirements for any future lock-up agreements by stating that "contractual expectation must yield to the supervening responsibility of the directors to discharge their fiduciary duties on a continuing basis."⁷²

While the results of the Omnicare case may not be fully realized yet, it is clear that ironclad lock-up agreements will not be tolerated by the courts.⁷³ In the first post-Omnicare case involving lock-ups the court allowed an agreement that included a voting agreement requiring the majority of shares to approve the merger along with a clause that in the event of a termination of the merger agreement the majority shareholders could not vote in favour of another merger for 18 months.⁷⁴ The court here applied the Unocal two-step test and determined that the terms in question were reasonable because the offeror required the lock-up before entering into any agreement and the terms were proportionate because they did not totally foreclose the target company from escaping the deal.⁷⁵ The court found that withdrawal was a realistic option in this case because there was no "mathematical certainty that the transaction would be approved as the Board had the possibility here

⁶⁵ *Omnicare, Inc. v. NCS Healthcare, Inc.*, supra n. 63, at 927.

⁶⁶ *Id.* at 936.

⁶⁷ *Id.* at 936.

⁶⁸ *Id.* at 936.

⁶⁹ *Id.* at 937, quoting *Paramount Communication Inc., v. QVC Networks Inc.*, 637 A.2d 34, 42 and 51 (Del. 1993).

⁷⁰ 8 Del.C. § 251(c).

⁷¹ *Omnicare, Inc. v. NCS Healthcare, Inc.*, supra n. 63 at 938

⁷² *Id.* at 939.

⁷³ Block, D., supra n. 47 at § VI.

⁷⁴ *Id.*, *Orman v. Cullman*, 2004 WL 2348395 (Del. Ch. Oct. 20, 2004).

⁷⁵ *Id.*

to recommend the shareholders not approve the transaction, which could stop the deal if the shareholders follow.⁷⁶

As with all of the deal protection mechanisms, lock-ups are allowed so long as they do not force the Boards to violate their fiduciary duties and are not so restrictive that the companies cannot escape the transactions. Penalties such as termination fees and the moratorium clause used on the Orman case may be allowed to essentially lock-up deals while leaving the directors and shareholders some form of out, no matter how remote the out. However the situation seems murky at this time as to where the line is between allowed and excessive, draconian, lock-up provisions with the major guidance being that if there is no mathematical certainty the deal will be approved by the shareholders the term may be allowed.

2.1.3 EU Legislation: The 13th Company Directive

After much debate and several failed attempts to enact EU takeover legislation, the Thirteenth Directive of the European Union on Takeover Regulation was approved in 2004 and required Member State Implementation by May 20, 2006.⁷⁷ Unlike US legislation, the Directive focuses on restricting the freedom of bidders in making offers and the measures which the target companies may enact to protect themselves from hostile takeovers.⁷⁸ As a result of the many years of negotiations and compromise required to accomplish the enactment of this directive, there are substantial freedoms granted to the MS related to the requirements of the Directive. The standards set forth in the Directive are often the minimum standards required, allowing a level of discretion for the MS to include more stringent standards in their implementing legislation.⁷⁹ Additionally, there are provisions allowing a MS to opt-out of certain articles, 9 and 11, but allowing individual companies to opt-in to the provisions of these Articles if they see an advantage in doing so.⁸⁰

The Directive requires mandatory bids be made for all the outstanding stock of a target company if one party acquires a certain percentage of a company which is determined by the country in which the company target company is incorporated.⁸¹ The purpose of the mandatory bid clause is to prevent a voting premium in the sale of shares, which is an artificially inflated price for shares until the offeror gains majority ownership and control of the

⁷⁶ Block, D. *supra* n. 47 at VI, *Orman v. Cullman* *supra* n. 74.

⁷⁷ Ventrone, M., *Europe's Thirteenth Directive and US Takeover Regulation: Regulatory Means and Political and Economic Ends*, 41 *Tex. Int'l L.J.* 171, 174 (2006), Council Directive 2004/25, 2004 O.J. (L 142/12) 12-23 (EC).

⁷⁸ *Id.*

⁷⁹ Council Directive 2004/25, 2004 *supra* n. 77.

⁸⁰ *Id.* at Article 12.

⁸¹ *Id.* at Article 5.

company.⁸² The mandatory bid rule protects all the shareholders by entitling them all to the same price for their shares. Under this article calling for mandatory bids there is a provision allowing MS a little leeway to determine rules regarding the price to be paid in these bids, requiring that the price is to be the highest price paid in a period of the MS' choosing between six to twelve months prior to the offer.⁸³ While this appears to be a provision which could allow an artificially high sale price during that period have a significant affect on the price of the takeover bid, there is a provision in the Directive allowing MS to predetermine extraordinary circumstances where national authorities may adjust the price.⁸⁴

While the mandatory bid provisions of the Directive place restraints on the bidding entity, there are also neutrality restrictions which determine how the target boards may act once a bid is received. The only active work by the target Board comes in the form of a public a statement of its opinion of the offer and its possible effects, including effects on employment.⁸⁵ Article 9 of the Directive sets out the neutrality requirements for the target Board and limits their actions. Once a corporation is aware that an offer will be made, the target Board cannot take any defensive actions that may impede the offeror's ability to acquire control of the entire company, unless shareholder approval is given prior to the defensive acts.⁸⁶ This neutrality rule severely limits a Boards ability to negotiate once an offer is received by allowing the Board to do so with explicit authorization after the offer or if it was given the power negotiate a merger at a shareholders meeting before the offer was known.⁸⁷

Article 11 of the Directive, the breakthrough rule, is designed to neutralize may the anti-takeover mechanisms available to companies in a battle for corporate control. This rule is drafted in a way that it acts to prevent the controlling group from entrenching its leadership position and create some uniformity in the rules throughout Europe.⁸⁸ Under the breakthrough rule, any restrictions, through corporate bylaws or shareholder agreements, on the transfer of securities or exercise of voting rights shall not apply during the time allowed to accept the bid.⁸⁹ Additionally, if one party owns 75% or more of the shares of a target company, the above agreements are invalid and any multiple vote securities only count for one vote, which, when coupled with the ability of the offeror to call a shareholders meeting in two weeks time to replace the Board and amend bylaws, virtually guarantees the offeror ownership.⁹⁰ This rule essentially pre-empts, or breaks through, any provisions that the Board may have enacted through voting agreements or securities transfers to fend off a hostile takeover.

⁸² Ventruruzzo, M., *supra* n. 77 at 192.

⁸³ Ventruruzzo, M., *supra* n. 77 at 174, Council Directive 2004/25, *supra* n. 77, article 9(5).

⁸⁴ Ventruruzzo, M., *supra* n. 77 at 208, Council Directive 2004/25, *supra* n. 77, article 5.

⁸⁵ Ventruruzzo, M., *supra* n. 77 at 208, Council Directive 2004/25, *supra* n. 77, article 9(5).

⁸⁶ Ventruruzzo, M., *supra* n. 77 at 208, Council Directive 2004/25, *supra* n. 77, article 9(2).

⁸⁷ Council Directive 2004/25, 2004 O.J. (L 142/12) 12-23 (EC) article 9(3).

⁸⁸ Ventruruzzo, M., *supra* n. 47.

⁸⁹ Council Directive 2004/25, *supra* n. 87, article 11(2).

⁹⁰ *Id.*

2.1.3.1 Optional Aspects of the Directive and Opt-in Rights

As a result of the controversy surrounding the breakthrough rule, and certain MS hesitance to accept this rule, the agreed upon compromise made the Passive and Breakthrough rules optional on a national level, subject to certain conditions.⁹¹ Under the Directive, MS have the option not to enact the breakthrough and passivity clauses, but if they do not enact them, individual companies within that MS may decide to apply these rules.⁹² Companies which choose to apply these rules retain the option not to apply the articles if they face a takeover bid from a company which does not apply the same articles as they do, or which is owned by a company that does not apply these provisions.⁹³

The final optional provision of the Directive is Article 12(3) which allows national law to exempt companies which apply the neutrality and breakthrough rules from doing so if they are subjected to a takeover bid from a company which is not subject to one or both of these rules.⁹⁴ This provision grants the companies a greater flexibility to “level the playing field” so that they are not subject to rules, which the offeror does not need to respect. This is an optional measure that has not been adopted by all MS therefore some companies may be subject to more rules than their offeror and thereby working at a disadvantage.

2.1.4 EU Board Duties

There is a remarkable difference between the role and duties of US and EU Boards in takeover transactions. While the US Boards take a very active role in any takeover negotiations and can even veto a deal without shareholder approval, a European Board must remain passive and neutral in these negotiations. The passivity and neutrality requirements significantly limit the defensive measures available to European Boards while placing more direct responsibility in the shareholders hands. The European view sees Board entrenchment as a US problem in corporate law and seeks to prevent this problem from become a major issue in the EU.⁹⁵

Under EU law there are two models regarding where a company may incorporate, the Incorporation Theory and the Real Seat Theory. The incorporation theory provides companies incorporated in one MS the flexibility to establish themselves other MS without having to meet the establishment requirements of those states. The Incorporation Theory is used in the UK, the Netherlands and Sweden, amongst other MS, and is the

⁹¹ Eloffson, J., *Lie Back and Think of Europe: American Reflections on the EU Takeover Directive*, 22 Wis. Int'l LJ 523 at 535 (2004).

⁹² Council Directive 2004/25, 2004, supra n. 87, Article 12(2).

⁹³ Id. at Article 12(3).

⁹⁴ Id.

⁹⁵ Kraakman, R., Davies, P., supra n. 28, page 165.

model closest to the US model as it allows the companies a fair amount of freedom in regards to where they may establish themselves. The second model of establishment within the EU is the Real Seat theory under which a company must be established in the country in which its principle place of business resides.⁹⁶ The real seat model is used in countries such as Germany and Denmark and prevents forum shopping by requiring companies that change their principle place of business to reincorporate in the MS of their principle place of business.

Under the European model of takeover legislation, Boards are virtually eliminated from the active decision making process, granting the shareholders significantly more power in a takeover transaction than their US counterparts.⁹⁷ This model prevents Boards from taking action to kill a bid before it reaches the shareholders, thereby limited directors' ability to entrench themselves in the management position.⁹⁸ However the European model does not disregard the Board altogether as it requires Boards to inform the shareholders of the effects of a bid and allows a Board to seek alternative bids.⁹⁹

2.1.4.1 General Implementation

Implementation of the Directive got off to a slow start with only six MS meeting the implementation deadline, but in the months after the deadline the situation improved and as of February 21, 2007, a total of 17 MS have transposed the Directive or adopted framework for transposition.¹⁰⁰ Looking at all MS, as of January 2007, eighteen implemented the Neutrality rule, three implemented the breakthrough rule, and fourteen implemented the reciprocity rule.¹⁰¹ These results were not unexpected as the majority of the MS had some form of neutrality rule before the Directive and the breakthrough rule was highly controversial so it is no surprise that it was not widely implemented.¹⁰²

2.1.4.2 United Kingdom Implementation

Much like the US, boards in the UK consist of one level of directors that manage the firm. The United Kingdom passed a company law reform bill, known as the "Companies Bill" on November 8, 2006, which replaced interim implementation to properly implement the Directive.¹⁰³ Many of the requirements set forth in the Directive were based on existing UK

⁹⁶ Case C-79/85 Segers (1986) ECR 2375, Craig, P. and De Búrca, G., *EU Law: Text, Cases and Materials*, Oxford University Press, 3rd ed., page 796-99 (2003).

⁹⁷ Kraakman, R., Davies P., supra n. 28, Page 165.

⁹⁸ Id.

⁹⁹ Council Directive 2004/25, supra n. 77, at Article 9.

¹⁰⁰ Commission Staff Working Document: *Report on the Implementation of the Directive on Takeover Bids*, (SEC 2007 268, 21.2.2007) page 4.

¹⁰¹ France implemented the reciprocity rule in regards only to the neutrality rule. Id. at Annex 1.

¹⁰² Id. at page 4.

¹⁰³ Company Law Reform Website, www.companieshouse.gov.uk/infoAndGuide/compLawReform.shtml

takeover legislation, which allowed the UK to implement the Directive with relative ease.¹⁰⁴

The UK is in total agreement with the Directive on the Mandatory Bid requirement and believes that without the option for minority shareholders to exit the company their rights will become subservient to those of the dominant shareholder.¹⁰⁵ The Mandatory bid rule is satisfied by Rule 9 of the Code, which requires that a party that acquires 30% or more of a UK company make a bid for the remainder of the outstanding shares.¹⁰⁶ The Bid shall be at a value equal to, or greater than, the amount that the acquiring party, or its agents, paid for each equal class of stock in the past twelve months.¹⁰⁷

The passivity requirements of the Directive are covered through a variety of Rules contained the City Code. Rule 21.1(a) of the code prevents directors from taking any action which, once a bid is imminent, may frustrate an offer or prevent the shareholders from the chance to vote on the offer without shareholder approval from a general meeting.¹⁰⁸ In compliance with Article 9.5 of the Directive, the Board must circulate to the shareholders an opinion of the effects of accepting the offer and the offeror's plans for the company, including employment issues.¹⁰⁹

This reformed bill puts the UK in conformity with the Breakthrough rule of the Directive by invalidating any agreements restricting, the transfer of shares during the offer period, the transfer of shares to anybody when the offeror holds 75% or more of the shares or restricts voting rights of shareholders at general meetings.¹¹⁰ Furthermore, a party owning 75% or more of the voting shares in a company may call a general meeting of the company.¹¹¹

In regard to the optional clauses, UK has chosen to enforce the neutrality rule while, however, opting out of the obligation to apply the breakthrough rule.¹¹² Furthermore, the UK does not grant its companies the reciprocity allowed under article 12(3) of the Directive,¹¹³ meaning that in the face of a bid from a company that is not subject to the neutrality or breakthrough rules the UK companies must still maintain these rules for themselves.

¹⁰⁴ Simpson, S., Baker, H., *The Future of Takeover Regulation in Europe*, 1575 PLI/Corp 725, § III (December 2006).

¹⁰⁵ *Explanatory Memorandum to the Takeovers Directive (Interim Implementations Regulations)*, 2006 No. 1183, Para. 32 (2006).

¹⁰⁶ City Code on Mergers and Takeovers, Rule 9.1.

¹⁰⁷ *Id.* at Rule 9.5.

¹⁰⁸ *Id.* at Rule 21.1.

¹⁰⁹ *Id.* at Rule 25.1.

¹¹⁰ Company Law Reform Bill § 643(2).

¹¹¹ Company Law Reform Bill § 644.

¹¹² Commission Staff Working Document, *supra* n. 100 at Annex 1.

¹¹³ *Id.*

2.1.4.3 German Implementation

The composition of German boards is unique from the UK in that it requires a vertical two-tiered structure for the larger companies. The two tiers consist of a supervisory board that is elected by the shareholders and a managing board that is appointed by the supervisory board and consists of the principle managers of the company.¹¹⁴ Furthermore, laws restrict shareholders electoral powers to ensure the presence of board representation from labour groups.¹¹⁵ Generally, the union representatives on a board make for increased opposition to any mergers which may have the potential to reduce the number of employees or employee benefits.¹¹⁶ The German Takeover Act was originally drafted in 2002, to provide boards with more flexibility than UK companies when it comes to frustrating takeover offers,¹¹⁷ which helps explain the relative low numbers of takeovers in German.

Germany's implementation legislation, the "Implementation Act" missed the deadline set in the Directive but came into force shortly thereafter on July 16, 2006.¹¹⁸ As in the UK, a mandatory offer must be made to the shareholders in the event that one party acquires 30% or more of a company's shares.¹¹⁹ German law sets the price for these mandatory bids, but also goes beyond the Directives requirements by setting a minimum amount for any bid. All bids must consist of a price of at least a weighted average of the share price for the three months before announcement that the bidder gained control, or that the bidder has made a bid in a non-mandatory setting, and the highest price paid by the offeror in the six months before the bid.¹²⁰

Germany has chosen to opt out of the prevention of actions frustrating a bid set forth in Article 9 and the breakthrough rule of Article 11.¹²¹ Much like the UK, Germany allows companies to opt-in to these provisions if they amend their Articles of Association by a vote of more than 75% of voting shares and inform the authorities of their decision to do so.¹²² Based on the decision of the companies whether or not to opt into Article 9 the availability of defensive measures varies. If the company decides not to opt-in, then after the bid is published the Boards may take no action except to maintain daily business, search for any alternate bids, actions approved by the companies Supervisory Board, and actions specifically authorized by the shareholders to Frustrate the Bid. These provisions allow the Managing Board to adopt defensive measures with the approval of the Supervisory

¹¹⁴ Kraakman, R., Davies, supra n. 28, page 35.

¹¹⁵ Kraakman, R., Davies, supra n. 28, page 36.

¹¹⁶ Ventrizzo, M., supra n. 77, at 208.

¹¹⁷ Simpson, S., Baker, H., supra n. 104, Part V.

¹¹⁸ Freshfields Bruckhaus Deringer, *The Takeover Directive: Implementation in Germany*, page 2 (July 2006).

¹¹⁹ Id at page 2.

¹²⁰ Id.

¹²¹ Id. at page 1.

¹²² Id. at page 1.

Board, rather than the shareholders, therefore easing the procedure and allowing the boards greater discretion to use defensive mechanisms.¹²³

Under German law, if the company chooses to opt-in to Article 9 of the Directive, once the bid has been published the Boards may only take actions approved at a shareholders meeting. Additionally, in this timeframe, these companies may take actions falling within normal business, actions that are not normal business but were decided and partially implemented before bid, and they may search for alternate bids.¹²⁴ As the German laws are less restrictive than the requirements of Article 9, it is expected that the majority of the companies will refrain from opting into the passivity rule of Directive.¹²⁵

Germany does not require companies to enact the breakthrough rule, and if a company wants to enact it, the company must declare that it subjects itself to this rule in its articles of association.¹²⁶ This will submit the company to the terms of Article 11 of the Directive, with the exception that it does not apply to any voting right restrictions on preference shares.¹²⁷ If voting rights are removed on a basis of the breakthrough rule, the shareholders are entitled to compensation provided the rights were established prior to the offer and were known to the company at that time.¹²⁸

Germany grants its companies the right to use the reciprocity rule of the Directive in order to allow the companies better defences to outside takeovers.¹²⁹ However, shareholders must authorize the use of the reciprocity provision by simple majority vote that grants the company reciprocity for a period of up to 18 months.¹³⁰

2.1.4.3.1 German “Golden Shares”

In addition to the rules set out in the German Takeover Implementation Legislation, Germany retains an additional, controversial, device to thwart the success of local takeovers, the use of “Golden Shares.” Golden Shares came into existence as a result of privatization and allow countries a level of control over the formerly nationalized company.¹³¹ Golden Shares provide the governments with certain rights including the right to prevent acquisition of shares, to make board appointments and to veto some corporate decisions, and have come under fire from the Commission because of their perceived negative effects on the free movement of

¹²³ Ventrizzo, M., *supra* n. 77, page 15-16.

¹²⁴ Freshfields Bruckhaus Deringer, *supra* n. 118, page 2.

¹²⁵ *Id.*

¹²⁶ In order to enact the breakthrough rule a German company must indicate in its articles of association that section 33b, paragraph 2 of the German Takeover code applies. *Id.* at page 2.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.* at page 3.

¹³⁰ *Id.*

¹³¹ O’Grady, C., *Limited But Not Lost: A Comment on the ECJ’s Golden Share Decisions*, 72 *Fordham L. Rev.* 2219, 2222 (2004).

capital.¹³² When examining the legality of Golden Shares the ECJ looks at the effect under a four-prong test to determine if this measure is applied in a non-discriminatory manner, is justified by the requirements of general interest, is suitable to achieve the goal, and is the least restrictive option available.¹³³ This test, coupled with ECJ rulings of 2003, led to the presumption that Golden Shares restrict the free movement of capital but they may be used on a limited basis when the MS can show good reason to do so in light of the above test.¹³⁴

While these Golden Shares may be used in Germany, if they are excessive they may be struck down by the court, as may be the result of a case currently before the ECJ involving state retained rights in Volkswagen. At issue in this case is one of the oldest Golden Share rights in Europe,¹³⁵ which limits shareholder voting power to 20%. In February of 2007, Advocate General Colomer declared that the rights in question prevented shareholders from acquiring more than 20% of the shares of Volkswagen because they would not have voting rights above that level.¹³⁶ While this is still at the level of an advisory opinion, if the ECJ affirms AG Colomer's decision, this could be another step in the direction of elimination of golden shares, and a blow to one German method of preventing takeovers.

2.1.4.4 Bid Protection Mechanisms in the E.U.

Due in part to the neutrality of EU Boards, especially relative to a US Boards activity in takeover bids, many of the bid protections mechanisms used in the US are not relevant or allowed in the EU. The bid protection mechanisms used in the US, including those discussed above, are used by the bidding company to ensure that they will be in an advantageous position in comparison to all other bidders. However, these mechanisms are generally not required, nor allowed, in the EU because the offeror does not have to worry about the EU Board vetoing its bid and sending a competing to bid to the shareholders with the Boards endorsement. Since it is the shareholders that have the power to accept and reject bids within the EU, bidding entities do not have to worry about making sure a board presents its offer to the shareholders.

Under the neutrality rule, and national implementing legislation, EU Boards may only take action related to takeover bids with the authorization of the shareholders, or the supervisory board when applicable in Germany.¹³⁷ As the Boards in the UK cannot take any actions to frustrate a bid, and German

¹³² Id. at 2223, Gordon, J., An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000, The Harvard John M. Olin Discussion Paper Series, discussion paper 406 (2003).

¹³³ Commission v. Gebhard, Case C-55/94 ECR I-4165, P 2.

¹³⁴ Gordon, J., supra n. 132, Footnote 151.

¹³⁵ The golden share rule in this case is 47 years old, making it one of Europe's oldest. Castle, S., *Volkswagen Court Ruling Sounds Death Kneel for the Golden Share*, The London Independent (February 14, 2007).

¹³⁶ Id, Commission v. Germany, C-112/05 (2007).

¹³⁷ Council Directive 2004/25, supra n. 87, Article 9(2).

Boards that do not opt-in to the neutrality rule are limited in this area, the offerors do not have to worry about protecting their bids because the target boards cannot take action to get out of the bid. Furthermore, the Board must evaluate all offers and present them to the shareholders to any agreement not to hear offers from additional bidders are irrelevant in the EU. The UK, however, allows a form of a break-up fee, called an inducement fee, that must be de minimus.¹³⁸ As the margin to approve any Board action that would be required for a bid protection mechanism is at such a high level, if there are enough votes to lock a company into a bid there are enough votes to approve the bid and the bid protection is not necessary.

While neither the UK nor Germany have enacted the Breakthrough rule individual companies that opt in, as explained above, may be subject to this provision. The breakthrough rule, when applicable, overrides the majority of bid protection mechanisms by voiding voting agreements and exit arrangements.¹³⁹ However, even when the breakthrough rule is an issue, it cannot defeat golden shares, thereby allowing an impenetrable defence in the rare event of golden shares. While very few MS have enacted this tool to render pre-bid takeover defences unenforceable, it led MS' to open their industry a little to the possibility of takeovers.¹⁴⁰

¹³⁸ Rule 21(2) of the City Code allows inducement fees that are no more than 1% the value of the offeree company, calculated from the offer price.

¹³⁹ Simpson, S., Baker, H., supra n. 104.

¹⁴⁰ Commission Working Staff Document, supra n. 100, page 7.

3 Defensive Measures

3.1 United States

The US corporate board is the guardian of the shareholders and that position permits boards to take certain actions to protect the shareholders from perceived undervalued takeover bids. US law allows boards to choose from a variety of defensive measures in attempts to thwart a hostile offer or create new innovative ways to protect the shareholders. The assumption with these defensive mechanisms is that the shareholders need protection; however, sometimes the reason for enacting these defences goes beyond the shareholders. One of the biggest criticisms of the US model, which allows boards to take active defensive measures without shareholder approval, is that the boards may act with their own best interests in mind and fight a takeover bid because they want to remain entrenched in power. Legally the boards are required to exercise their fiduciary duties when considering defensive measures, especially the duty of loyalty, but it is unclear if that is always the reality.

3.1.1 Poison Pill

One of the most common defensive tactics taken by a target company is known as a poison pill, where the existing shareholders receive a right to acquire shares at a significant discount or be bought out at a substantial premium if a stated event occurs, such as changes in ownership or one party acquiring a substantial number of shares.¹⁴¹ Under the poison pill design, if a hostile bidder acquires a certain percentage of the company the Board may issue large amounts of stock, debt, securities or cash to the shareholders.¹⁴² Boards are granted the power to enact these provisions through Delaware statutes as well as case law.¹⁴³ The Boards have the option to revoke these defences so that they may sell in the future. The poison pill is one of the most implemented defensive tactics because by design it is never actually used, it is much like a nuclear bomb in that the deterrence factor of the threat of its use is enough to scare away the bidder and if it is ever used the company will be left in ruins.

3.1.2 White Knight

When it becomes apparent to a board which is a target of hostile bids that its company will eventually be acquired the Board may seek ways to have a friendly company take them over so as to ensure the best interests of the Company. A white knight transaction exists where the target board seeks

¹⁴¹ *Revlon*, 506 A.2d at 184, supra n. 36, at 180

¹⁴² Gordon, J., *An American Perspective on the New German Anti-takeover Law*, Columbia Law School: The Center for Law and Economic Studies: Working Paper 209, pages 1-2 (2003).

¹⁴³ *Moran v. Household Int'l. Inc.*, 500 A.2d 1346 (Del. 1985).

out friendly companies that will outbid the hostile offer, thereby meeting the Boards fiduciary duties, but will remain friendly to the existing management.¹⁴⁴ This mechanism is allowed under Delaware law, so long as the board meets its Revlon duties by ensuring that the total value of the bid is above that of the hostile bid, and is beneficial in situations where the Board is concerned that the company may be broken up after a hostile bid and wants to protect its future by arranging for a friendly takeover.¹⁴⁵ The target Board is allowed to favour the bid of a white knight over that of a hostile party only in situations where the hostile offer adversely affects shareholder interests, in all other situations the Board must treat both parties equally.¹⁴⁶ The downside to this mechanism is that the Board may be subject to a longer process to complete the transaction than the hostile bid due to the regulatory issues which the hostile bidder has a head start, in relation to the white knight, which must start the process much later.¹⁴⁷ This is a good mechanism to protect a company, when it is clear that it cannot fend off the hostile bidders on its own, by making the best of the situation and looking out for the company, and possibly creating a bidding war that should benefit the shareholders.

3.1.3 Golden parachute

Golden parachutes are financial provisions that seek to make the target company less desirable by granting significant cash or stock benefits to the managers in the event of a change of control.¹⁴⁸ The theory behind these provisions is that the payouts resulting from these contracts will act to decrease the attractiveness of the target company because the large amount of capital that must be given to the directors will decrease the equity of the target company. In reality the effectiveness of these provisions is minimal because the payments amount to a nominal sum when looking at the total bid and value of the target company.¹⁴⁹

3.2 European Union

The neutrality requirement of EU boards make it nearly impossible to enact these defensive measures, and in cases where the breakthrough rule applies the defences may be defeated before they have any effect on the bidding company. Unlike the US boards, EU boards often need shareholder authorization to take the action required to enact one of these defensive measures, and when there are enough votes to enact these measures they are, in reality, unnecessary for the companies. If there is enough shareholder opposition of a bid to muster the votes to authorize one or more of these

¹⁴⁴ Herlihy, E., *Contests for Corporate Control 2007: Current Offensive & Defensive Strategies in M&A Transactions*, 1584 PLI/Corp 433, 516 (2007).

¹⁴⁵ Id.

¹⁴⁶ *Revlon*, 506 A.2d at 184, supra n. 36, at 184.

¹⁴⁷ Block, D., supra n. at 147.

¹⁴⁸ Id. at 516.

¹⁴⁹ Id. at 147.

protective measures then there will be enough votes to defeat the merger entirely, therefore these defensive mechanisms may be largely irrelevant.¹⁵⁰

3.2.1 Poison Pill

If EU countries, or their companies, opt in to the neutrality rule, the breakthrough rule, or both, then a poison pill will have no effect on the outcome of a takeover bid. In companies that are subject to the neutrality rule, if the shareholders are opposed to the bid strongly enough to authorize a poison pill then they do not need one because they can defeat the merger. Where the Breakthrough rule applies, it will defeat a poison pill by design, so that even if the Boards have existing poison pill mechanisms set up before a takeover bid it will neutralize these devices.¹⁵¹

3.2.1.1 U.K.

The use of poison pills in the UK is legal but not as widespread as in the US for a variety of reasons. Poison pills fall under Rule 21 of the city code, in compliance with the neutrality rule, which prevents the creation or issuance of securities and options, in the manner a company would in adopting a poison pill, without shareholder approval.¹⁵² The shareholder protection provided by a poison pill is not necessary in the UK because the shareholders do not rely on the board to protect them, but rather they are active in the decision making process and can protect themselves by defeating a takeover bid.

3.2.1.2 Germany

While German boards technically have the availability to enact a poison pill, it is not feasible in reality and thus not a viable defence.¹⁵³ Much like in the UK, boards must gain shareholder approval to enact a pre-emptive defensive right, such as a poison pill, and the company would face legal hurdles, as this move would be seen by regulators as an attempt to increase the company's capital.¹⁵⁴

3.2.2 White Knight

Under the neutrality rule the one course of action an EU Board may take without shareholder approval, when faced with a takeover bid, is to seek a white knight.¹⁵⁵ This right enforces the EU emphasis on shareholder interests by enabling the Board to arrange for multiple offers so that the

¹⁵⁰ Elofson, J., supra n. 91 at 547.

¹⁵¹ Ventrizzo, M., supra n. 77, at 194.

¹⁵² City Code on Takeovers, Rule 21.1.

¹⁵³ Gordon, J., supra n. 142, pages 5-6.

¹⁵⁴ These measures would require 75% shareholder approval and be subject to the German capital laws contained in AktG § 192. Id.

¹⁵⁵ Ferrarini, G., Hopt, K., Wymeersch, E., *Capital Markets in the Age of the Euro: Cross-Border Transactions, Listed Companies and Regulation*, Kluwer Law International, page 411 (2002).

shareholders themselves may choose the offer, if any, which they believe to be in their best interest.¹⁵⁶

3.2.2.1 U.K.

The UK permits boards to seek a white knight so long as they do not favour the potential white knight and they meet the requirements set forth in the City Code. Under City Code Rule 20.2, a Board cannot furnish its white knight with more or different information than is provided to the other offerors,¹⁵⁷ essentially prohibiting the Boards from acting to encourage one bid rather than the other but allowing two parties an equal playing field to bid for the company and let the shareholders decide the best course of action.

3.2.2.2 Germany

As Germany has not opted into the passivity requirements, German companies that have not individually opted in have more freedoms in seeking a white knight than their UK counterparts. The non-neutral companies maintain enough control on a board level to search for additional bids, and take other actions approved by the supervisory board that may increase the chance of an additional bidder.¹⁵⁸

3.2.3 Golden parachute

Generally, the economic viability of golden parachutes as a defensive mechanism is questioned in the EU and this mechanism does not fit in with the requirement of neutrality.¹⁵⁹ Golden parachutes are permitted defensive mechanisms in the EU if the company is not subject to the neutrality rule, but because of national moves towards restraints on compensation of directors and managers the amount of money at issue in the EU is usually less than the US, and therefore not as damaging to the offeror.¹⁶⁰ If the neutrality rule applies, a board may not stage a golden parachute defence without shareholder approval, because doing so does not comply with the legal requirements of the neutrality rule. In addition to the legal implications of golden parachutes themselves, executive compensation has become a social issue in the EU, with many citizens questioning these high payments, which may lead to legal backlash in the near future.¹⁶¹

¹⁵⁶ Id. at page 411.

¹⁵⁷ City Code Rule 20.2.

¹⁵⁸ Freshfields Bruckhaus Deringer, supra n. 118, page 2.

¹⁵⁹ Ferrarini, G., Hopt, K., Wymeersch, E., supra n. 155, page 416.

¹⁶⁰ Ventoruzzo, M., supra n. 77, at 210.

¹⁶¹ Cala, A., *France Joins EU Trend to Rein In Executive Severance Deals*, Wall Street Journal, Page A13. June 8, 2005.

3.2.3.1 U.K.

The City Code prevents the enactment of golden parachutes if the Board has reason to be aware of a pending bid through a clause preventing the Board from entering into contracts other than those in the ordinary course of business.¹⁶² In accordance with this rule, introducing new contracts for the directors and managers with the provisions required for a golden parachute defence would be entirely contrary to this provision if it is determined that such contracts exceed the ordinary course of business. Additional deterrents to the use of this come from British backlash against excessive executive salaries limiting golden parachutes to one years salary and allowing for shareholders to enter into a non-binding vote on executive pay and severance packages.¹⁶³

3.2.3.2 Germany

Generally, the lack of neutrality of a German board allows greater flexibility to stage a golden parachute defence than the UK boards. Indemnification at severance and retirement payments are not objectionable under German law.¹⁶⁴ However, the use of this device has come under question in Germany after a trial involving a 57 million Euro payment in the Mannesmann takeover, which was permitted but has created questions about executive compensation.¹⁶⁵ As a deterrence to issue excessive salaries, German legislation has been introduced which will require executive salaries to be public information,¹⁶⁶ possibly creating a social outcry against these high salaries which would act as golden parachutes.

¹⁶² City Code Rule 21.1(b)(i)(v).

¹⁶³ Cala, A., supra n. 161.

¹⁶⁴ Ferrarini, G., Hopt, K., Wymeersch, E., supra n 155, page 416.

¹⁶⁵ Cala, A., supra n 161.

¹⁶⁶ Id.

4 Comparative Analysis

Looking at the US and EU Boards in relation to their roles in a takeover bid, it is clear that the US Boards have a very active role in takeovers, while their EU counterparts take a step back and let the shareholders take control.

As stated above, critics of the US system point to its effect of allowing Boards to entrench themselves and ward off takeover attempts to retain their positions. While the US Boards face a duty to maximize shareholder value and should accept offers if they will provide the shareholders with the best returns possible, these Boards can reject bids they should accept and hide behind the business judgment rule. The US makeup lets the Board speak for the shareholders and if the Board can provide information that the decision to reject a takeover was made based on actual business decisions, even if they are not good decisions, they may successfully defend a bid rejection that they should have accepted for their shareholders.

The theory behind the neutrality rule is that takeover bids should not be impeded so all defensive measures must be looked at critically, which is called into question as the Board is acting as a Trustee for the shareholders so it must not frustrate a takeover bid if it will benefit the shareholders.¹⁶⁷ As the US system may grant the Boards too much power, the opposite may be argued of the EU Boards, which lack the power to take any significant actions in the face of a takeover bid, without shareholder approval. The Board power in the UK is especially limited because of the neutrality rule, granting the shareholders an extraordinary amount of power. The German system allows the Board more flexibility in their response to takeover bids and the composition of these Boards with labour representation works to empower employees as well as shareholders. However, neither board is completely free to act as they see fit without approval from some other party. Examining the options available to EU boards gives some the opinion that defences in Europe are at the same stage as they were in the US in the 1970's and 80's in that they will be limited to actions which may create competition problems for the acquiring company.¹⁶⁸

Almost a year after the transposition deadline, not all EU states comply with the requirements, and the effects of the Directive are still in question.¹⁶⁹ At first glance, the Directive leads an outsider to believe that there is a high degree of harmonization of EU takeover laws but that appears to be far from reality. Looking at the UK and Germany shows the possible levels of divergence in EU use of defensive measures, which indicates the playing field in EU takeovers is not as level as the Commission would like. Even with all MS-to-MS differences in the application of defensive mechanisms,

¹⁶⁷ Guido Ferrarini, Klaus J. Hopt, and Eddy Wymeersch, *supra* n. 155, page 403.

¹⁶⁸ Godon, J., *supra* n. 142, page 6.

¹⁶⁹ Commission Staff Working Document, *supra* n. 100, page 10.

one thing remains certain, EU boards have nowhere near the level of control over the defensive of a company as their US counterparts.

While the US, like the EU, is not totally harmonized in the field of takeover law, the race to the bottom in Delaware creates a position where most US companies are subject to the same laws. The US boards are afforded a great level of control and defensive options in takeover transactions so long as they meet their duties to maximize shareholder value and remain loyal to the company.

As mergers take place in a business environment, one must look at more than just the laws when evaluating which approach, if any, is better for the companies and the markets on which they operate.

5 Conclusion

The US and EU take very different approaches to the boards duties in corporate takeovers but it remains unclear which of the methods is better. It is argued that defensive measures “prevent transactions at the expense of the shareholders” and “they aren't a significant threat unless the ownership base is consolidated because in a diverse base, people will vote to waive if necessary.”¹⁷⁰ If this is the case then defensive measures are inefficient tools that seek to overpower market forces which move towards consolidation and efficiency.

The US approach of granting the board widespread discretion to enact defensive measures comes under criticism because, even in light of the Board duties, abuse by the directors is very real and it is the shareholders who suffer when their Boards abuse power. This approach essentially grants the Board excessive power over the shareholders and allows few to control the company. While it is the case that directors should be more informed in matters of their company than the shareholders and therefore better prepared to make the decisions for the shareholders there is no way to ensure that the directors are acting in the best interest of the shareholders. The business judgment provides the directors with a wide scope protection for their moves so long as they can prove that the actions were based on an informed business decision. This rule enables director abuse and, if the directors meet its requirements, may shield them from any repercussions other than removal from their at the next meeting, not a proportionate punishment for abusing power at the expense of, potentially, thousands of shareholders. The US approach allows the directors to fight for control of their company, but the rationale of the active board may be questioned.

Recent data indicates that about 80% of mergers fail in the long run and 40% of these acquisitions are resold in 3-5 years.¹⁷¹ These numbers may be skewed by the amount of takeover transaction that, by design, result in companies being broken up and sold off in pieces shortly after the takeover, but they may be some truth to the fact that these mergers end up hurting one of both of the companies involved rather than improving their business. The effect of takeovers on employees can be demoralizing, especially after a hard fought hostile takeover, as the employees often view the acquirer as the enemy and are reluctant to embrace their policies.¹⁷² In light of this evidence the EU approach with less board involvement may prove to be better for the company and shareholders alike.

For all of the US efforts to promote democracy throughout the world, it is the EU that has integrated democratic decision making with its corporate world. Under this approach, no matter what the outcome of a takeover in

¹⁷⁰ Interview with Joel Russ, Vice President, Audax Group (May 11, 2007).

¹⁷¹ Johnson, R., Why 80% of all Acquisitions Fail, Supply House Times (April 2006).

¹⁷² Id.

the long run, shareholders are the ones who make the decision and therefore they should have no conflict of interest issues and nobody to blame but themselves if the deal ends up hurting the company in the long run. This approach may not result in the most informed people making the decisions in a takeover, but it does put the biggest decisions in the hands of the party most interested in the transaction. Additionally, defensive measures have come under criticism from both scholars and industry experts, and the EU seeks to avoid any problems by allowing the measures only where it is clear that the shareholders want to protect their company. This method of only enacting defensive measures when there is a clear shareholder interest in doing so, acts more to send the message to an offeror that they won't sell than if it is a small group of directors fighting off the acquirer, as is the case in the US. The EU approach appears to be better suited to meet the desires of the shareholders but the methods enacted in the Directive do not lead to EU harmonization in this field and come under heavy criticism.

The compromises required to pass the Directive resulted in a less potent policy than many desired and the requirements of this Directive are largely optional which may be viewed as a step towards harmonization, but if so it is a baby step. The breakthrough rule appears to be a useful method to neutralize defensive measures but the reality is that only approximately 20% of EU companies have the structure and voting agreements that would make them vulnerable under the breakthrough rule.¹⁷³ Taking consideration of all of the relative variables, the breakthrough rule will only affect 3-4% of EU companies if it is implemented in every MS, making the number much smaller in reality.¹⁷⁴ This relatively small percentage of effected companies will not create the level playing field desired by the directive. The neutrality rule has its own weaknesses, including that it allows takeover offers to be approved at lower prices than the US because sometimes defensive measures lead to higher bids. Based on the Commission's own report, stating that it will probably revisit the Directive before the original review date of 2011, it does not appear that this directive is living up to its expectations.¹⁷⁵

Both of the discussed approaches have their advantages and their problems, and based on the multiple highly complex variables that exist in the world of corporate takeovers it is unlikely that any approach will satisfy all of the critics. It appears that for at least the near future the takeover market will remain divided with the US model promoting active boards and defensive measures and the EU model working towards the Directive's goal of a level playing field with the decision making power resting in the shareholders.

¹⁷³ As of 2003, evidence suggests that only 20% of EU companies would be vulnerable under the breakthrough rule and of those only 200 companies would be made vulnerable. Coates IV, J., *Ownership, Takeovers and EU Law: How contestable should EU Corporations be?*, (2003).

¹⁷⁴ *Id.*

¹⁷⁵ Commission Staff Working Document, *supra* n. 100.

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