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To breakthrough or not

A study in economic efficiency

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Summary

This thesis evaluates under which circumstances it is advantageous to implement the breakthrough rules of the takeover directive. Methodology from normative law and economics is used to construct a three-step test which allows the breakthrough rules to be tested against varying methods of separating control rights from cash-flow rights.

Little evidence is found to support the implementation of the breakthrough rules on the level of a member state. This conclusion is based on the fact that in some instances the breakthrough rules do not affect the methods used to separate cash-flow rights from control rights and that the rules are often possible to evade in those cases where the rules do effect the control mechanisms.

The same conclusion is reached when the case for implementing the rules is studied for an individual company. The possible exception to this negative view is the case of initial public offers. The special situation in this case, where investors have an increased leverage over the founders of the company may produce situations where it could be advantageous to implement the breakthrough rules through the corporate charter. The requirement to pay compensation to a controlling shareholder whose rights are removed by the breakthrough rules is found to affect the utility of the rules adversely in these cases.

Sammanfattning

Uppsatsen utvärderar under vilka förhållanden det är förmånligt att införa genombrottsreglerna i direktivet om uppköpserbjudanden. Metodologiskt används metoder från normativ rättsekonomi för att skapa ett trestegstest. Detta test gör det möjligt att pröva genombrottsreglerna mot olika metoder för att separera kontroll- och kassaflödesrättigheterna i bolag.

Slutsatsen blir att det finns mycket begränsat stöd för medlemsstaterna att välja att införa genombrottsreglerna. Detta baseras på dels det faktum att reglerna dels inte påverkar vissa sätt att skaffa sig en kontroll som överstiger kassaflödesrättigheterna och dels det faktum att det ofta är möjligt att kringgå reglerna i de fall de skulle kunna ha verkan.

Samma slutsatser gäller möjligheten att införa genombrottsreglerna för ett enskilt bolag. Ett möjligt undantag till denna annars avvisande syn på att införa genombrottsreglerna framträder i samband med att börsnoteringar studeras. Denna situation är speciell i det att investerarna möjligen har en starkare förhandlingsposition vilket i vissa fall kan göra det intressant att införa genombrottsreglerna i bolagsordningen. Kravet på att betala kompensation för rättigheter som förloras genom genombrottsreglerna påverkar deras nytta negativt i dessa fall.

Preface

This thesis is the culmination of several years of study during which my family has had to put up with my periodic absence, both physically and mentally. I am indebted to them for their understanding which has allowed me to take the opportunity to study for a law-degree.

Beyond that I wish to thank my supervisor, Marco Claudio Corradi, for his inspiration and guidance. It has been instrumental in the writing of this thesis.

Abbreviations

CJEU	Court of Justice of The European Union
EEC	European Economic Community
EU	European Union
IPO	Initial Public Offering
US	United States of America

1 Introducing the problem

A hypothetical example shows the different effects of implementing the optional breakthrough rules of the takeover directive or not. Having briefly commented on the takeover directive the purpose of the thesis, to evaluate under what circumstances it is advantageous to implement the breakthrough rules is stated. After stating the research questions of the thesis earlier research into the desirability of implementing the breakthrough rules is noted and the remainder of the thesis is outlined.

1.1 The different realities facing a bidder

Consider two hypothetical takeover bids targeting companies within the European Union (EU).¹ The bids take place within different member states of the Union. In both cases someone interested in acquiring the shares of the target company makes an offer to purchase them, either with the consent of existing controlling shareholders or, in case of a hostile takeover bid without such consent.² The two situations are comparable and in both cases an existing non-majority shareholder in practice controls the company.³

The idea that a non-majority shareholder can in practice control a company is not far-fetched. In fact, we find that it is in many cases possible to control a company while owning less than half of the cash-flow rights through different mechanisms.⁴ This control can stem from control mechanisms employed by the controlling shareholder or the costs that the minority

¹ Shailendra (Shail) Pandit, *Takeover strategies* in H. Kent Baker and Halil Kiyamaz (eds.), *The art of capital restructuring: creating shareholder value through mergers and acquisitions* (Wiley, Hoboken, N.J., 2011)

² Marco Ventrizzo *Comparative corporate law* (West Academic, St. Paul, Minn., 2015) 519; Pandit (n 1) 323.

³ Ventrizzo (n 2) 520 discusses the fact that de facto control of a company can be exercised without controlling a majority of the shares or even of the votes at a general meeting.

⁴ Ventrizzo (n 2) 520; Lucien A. Bebchuk and Reinier Kraakman and George Triantis, *Stock Pyramids, Cross Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from cash-Flow Rights* in Randall Morck (eds.), *Concentrated corporate ownership* (University of Chicago Press, Chicago, 2000) 295f.

shareholders would have if trying to coordinate their actions.⁵ In this hypothetical example we assume that the controlling shareholder has protected its controlling position through differentiated voting rights.⁶

In one case, national law has implemented the breakthrough rules of Directive 2004/25/EC on takeover bids⁷ which will be referred to as the takeover directive throughout the thesis. The voting rights of the shares of the target company are in this case equalized with respect to the takeover bid despite the efforts of the controlling shareholder to protect its position. This raises the possibility of the protective measures put in place by the controlling shareholder being neutralized.⁸ In the other case, the member state has opted not to implement the breakthrough rules and they have not been voluntarily incorporated into the corporate charter either.⁹ The end result of the breakthrough rules not being implemented is that the differentiated voting rights are left untouched, possibly allowing the controlling shareholder to maintain control.

The fact that member states and indeed individual companies are given the option to implement or not to implement the breakthrough rules is clear from the text of the directive.¹⁰ What is not self-evident is under what conditions it is advantageous for a member state or an individual company to choose to implement the breakthrough rules.

1.2 The affected control mechanisms

The breakthrough rules are named after their purpose of breaking through or modifying control mechanisms that may be used by controlling shareholders

⁵ Bebchuk et. al. (n 4) 295-296 on control mechanisms; Stephen M. Bainbridge, *Investor Activism: Reshaping the Playing Field?* (May 2008 UCLA School of Law, Law-Econ Research Paper No. 08-12) 6 on the rational apathy of dispersed shareholders.

⁶ Bebchuk et. al. (n 4) 297f contains a short overview of shares with differentiated voting power and examples from Sweden.

⁷ DIRECTIVE 2004/25/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 21 April 2004 on takeover bids. Hereafter cited as the Takeover Directive.

⁸ Takeover directive, art 11 contains the breakthrough rules.

⁹ Takeover directive, art 12 contains the possibility or right to implement the breakthrough rules through the corporate charter.

¹⁰ Takeover directive, art 12.

to maintain control over companies. The common denominator is that these control mechanisms to some degree separate the power over the company from the amount of capital invested in the shares.¹¹ In this thesis, using the terminology of Bebchuk, Kraakman and Triantis, the power over the company is termed control rights since it signifies the right to control the decisions of the company.¹² The invested capital is termed cash-flow rights since it forms the basis for calculating the right to receive disbursements from the company, for example in the form of dividends.¹³

Ownership structures of listed corporations and the effects on control rights can vary considerably. At one extreme are the widely held corporations whose dispersed ownership means that no one owner can exert control over the company. In this case control rights and cash-flow rights are aligned with each other in regard to the shareholders who are in focus in this thesis.¹⁴ The relationship between shareholders as a class and management may well be different in that management may be able to exert control over company decisions out of proportion to any cash-flow rights but lies outside the scope of this work.¹⁵ At the other extreme are found companies where one controlling shareholder in practice can dictate the decisions of the company or holds an outright majority of the shares.¹⁶ This control can also be achieved by a small group of shareholders acting in concert.¹⁷

In most corporations, a shareholder controlling fifty percent plus one of the shares has the ability to control the decisions of the general meeting.¹⁸ Due

¹¹ Bebchuk et. al. (n 4) 295-296.

¹² Bebchuk et. al. (n 4) 297.

¹³ Bebchuk et. al. (n 4) 297.

¹⁴ Bebchuk et. al. (n 4) 295-297.

¹⁵ Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure* (July 1, 1976) in Michael C. Jensen, *A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS AND ORGANIZATIONAL FORMS*, (Harvard University Press, December 2000; *Journal of Financial Economics (JFE)*, Vol. 3, No. 4, 1976) 10-12.

¹⁶ Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative taxonomy* (119 *Harv. L. Rev.* 2006) 1643.

¹⁷ Gilson (n 14) 1643.

¹⁸ Yu-Hsin Lin, *Controlling Controlling-Minority Shareholders: Corporate Governance and Leveraged Corporate Control* (2017 *Colum. Bus. L. rev.* 453, 510 2017) 456-458 establishes the 'one share/one vote' principle giving an allocation of voting rights in relationship to cash-flow rights as the default condition and gives examples of exceptions to

to the fact that small shareholders in many cases do not find it rationally worthwhile to expend the resources necessary to discipline management it is in practice often not necessary to have outright legal control over a corporation to be able to control it in practice.¹⁹ It has been reported that it is in many cases possible to have practical control of corporate decisions while owning significantly less than half of the shares.²⁰

This implies that in practice it is possible to control a corporation without owning the matching cash-flow rights.²¹ Since dividends are paid equally to all shareholders in proportion to the cash-flow rights owned it also opens up the possibility for a controlling shareholder to siphon off private benefits of control that reduce the dividends and to some extent are paid for by the remaining majority of shareholders.²² These private benefits of control can for example take the form of preferential pricing vis a vis other corporations controlled by the same controlling shareholder.²³

There are several techniques available to a controlling shareholder who wishes to minimize the amount of capital or cash-flow rights required to retain control over a particular corporation. Bebchuk, Kraakman and Triantis divide these strategies into differential voting rights, stock-pyramids

this rule; Wolf-Georg Ringe, *Deviations from Ownership-Control Proportionality - Economic Protectionism Revisited* in COMPANY LAW AND ECONOMIC PROTECTIONISM - NEW CHALLENGES TO EUROPEAN INTEGRATION U. Bernitz and W.G. Ringe, eds., (OUP, 2010; Oxford Legal Studies Research Paper No. 23/2011) 209-210; Stefan Grundmann and Florian Möslein, *Golden Shares - State Control in Privatised Companies: Comparative Law, European Law and Policy Aspects* (April 2003) 1-2 discusses the use by states of golden shares to retain a degree of control in companies that are being privatized as one exception.

¹⁹ Edward B. Rock *The Logic and (Uncertain) significance of Institutional Shareholder Activism* (79 *Goe. L.J.*, 1991) 455 discusses under what circumstances it is rational for a shareholder to expend the necessary resources; Ventrone (n 2) 520 discusses the fact that control is in many instances achievable with significantly less than half the votes.

²⁰ Ventrone (n 2) 520.

²¹ Bebchuk et. al. (n 4) p. 295

²² Luca Enriques and Henry Hansmann and Reinier Kraakman and Mariana Pargendler, *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies* in Reinier H. Kraakman (ed), *The anatomy of corporate law: a comparative and functional approach* (Third edn, Oxford, 2017) 79-80; Hyun-Chul Lee, *The Hidden Costs of Private Benefits of Control: Value Shift and Efficiency* (29 *J. Corp. L.* 2004) 720-721 on the value shifting aspects of private benefits of control.

²³ Lee (n 22) 721 exemplifies private benefits of control.

and cross-ownership.²⁴ Of these the differential voting rights are part of the corporate charter while the other two techniques lie outside it.²⁵

The theory behind differentiated voting rights as a method for creating a controlling minority shareholder position is simple. Some shares are assigned a higher number of votes than others that carry the same nominal investment.²⁶ There is in theory no limit to the difference in voting power and examples of 1000 to 1 ratios have earlier been reported from Sweden.²⁷ Bebchuk, Kraakman and Triantis report that this at one time allowed the company Investor in Sweden to control 95 percent of the votes in Electrolux with only 7 percent of the capital and matching cash-flow rights.²⁸

The principle of differentiated voting rights taken to its extreme implies that certain shares carry no voting rights at all, for example class C shares in Facebook carry no voting rights at all.²⁹ Such shares exist in two forms, those that carry a preferential right to dividends and those that do not.³⁰ Both types exist within the EU with the preferential type being more common.³¹ The preferential non-voting share is not necessarily a method for enhanced control, it can also be a way of attracting investment capital by more closely tailoring the role of equity to the specific situation at hand.³²

²⁴ Bebchuk et. al. (n 4) 295.

²⁵ Bebchuk et. al. (n 4) 297. The authors note that pyramids and cross-ownerships require multiple firms.

²⁶ Bebchuk et. al. (n 4) 297-298.

²⁷ Lucien Bebchuk and Oliver Hart, *A Threat to Dual-Class Shares* (Financial Times May 31, 2002) 1 reported a ratio of 1000 to 1 in the case of the Swedish company Ericsson in 2002. Presently Swedish corporate law allows a maximum differential of 10 to 1 (4 kap. 5 § Aktiebolagslagen (2005:551)).

²⁸ Bebchuk et. al. (n 4) 298.

²⁹ Institutional Shareholder Services (ISS) and Shearman & Sterling LLP and European Corporate Governance Institute, *Report on the Proportionality Principle in the European Union* (2007) 19. Lin (n 18) 491-493 regarding the case of Facebook.

³⁰ Ronald J. Gilson and David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock* (February, 2002 Columbia Law and Economics Working Paper No. 199; Stanford Law and Economics Olin Working Paper No. 230) 8-9.

³¹ ISS et. al. (n 29) 19.

³² George C. Triantis, *Financial Contract Design in the World of Venture Capital* (University of Chicago Law Review, Vol. 68, Winter 2001) 10-12.

The non-preferential type is allowed in some EU member states but is not reported to be commonly used.³³

Moving beyond the corporate charter corporate pyramids are reported to be a more common technique for controlling minority shareholders within the EU than differential voting rights.³⁴ This approach uses a series of companies, the first one owning a controlling share of the next which might then own a controlling share of yet another company.³⁵ With no more than 3 layers involved it can be shown that it is possible to control the company in the third layer while owning as little as 12,5 percent of the corresponding cash-flow rights.³⁶

If the corporate pyramid scheme concentrates the control in one company a cross-ownership scheme instead spreads it horizontally across a set of companies that own shares in each other.³⁷ In this way the relatively small share that the controlling owner owns in a given company is augmented by the similar blocks owned by other companies in the scheme.³⁸ The net result is that the controlling shareholder has a much greater degree of control than the cash-flow rights.³⁹ This method for separating control and cash-flow rights is also used within the EU but less common and more regulated than the use of pyramids.⁴⁰

Alongside these methods shareholder agreements can also be used to gain greater control rights than would otherwise follow from the cash-flow rights. By allying him or herself to other shareholders through contractually binding agreements a shareholder can create a block of shareholders that together have effective control of the corporation.⁴¹ This allows a smaller

³³ ISS et. al. (n 29) 19.

³⁴ ISS et. al. (n 29) 19.

³⁵ Bebchuk et. al. (n 4) 298-299.

³⁶ Bebchuk et. al. (n 4) 298-299.

³⁷ Bebchuk et. al. (n 4) 299

³⁸ Bebchuk et. al. (n 4) 299-300.

³⁹ Bebchuk et. al. (n 4) 299-300.

⁴⁰ ISS et. al. (n 29) 22.

⁴¹ Ventoruzzo (n 2) 445.

capital investment than would be required in order to have a controlling stake without the shareholder agreement.⁴²

These strategies complement each other in practice and have different strengths and weaknesses. The charter based strategy has the advantage that actions taken in violation of the provisions in many cases are legal nullities and have no effect.⁴³ For example, a share transfer in violation of a charter provision has no effect.⁴⁴ On the other hand charter provisions are public knowledge and should circumstances change a majority can change them against the wishes of the controlling shareholder.⁴⁵

Using contractual agreements as a strategy for corporate control has the possible advantage of being out of the public eye, at least in those jurisdictions where they do not need to be disclosed. The agreements are as contractual agreements and as such secret and may in the absence of legislation demanding disclosure never become public.⁴⁶ On the other hand a violation of the agreement does not imply nullity. Quite to the contrary, a share transfer in violation of a shareholder agreement is in many cases binding on the seller and buyer. The only recourse for the wronged party to the agreement is to sue for damages.⁴⁷

All these strategies which can serve to give a shareholder control over a corporation also protects the controlling shareholders position during a takeover bid. This works in the same way as during the normal operations of the corporation by giving control rights in excess of the cash-flow rights owned by the controlling shareholder, for example when a general meeting votes on defensive measures in conjunction with a takeover bid.⁴⁸ These control rights can then be exercised in case of someone making a takeover

⁴² Ventrizzo (n 2) 462.

⁴³ Ventrizzo (n 2) 425.

⁴⁴ Ventrizzo (n 2) 425.

⁴⁵ Ventrizzo (n 2) 425 notes that shareholder agreements instead of charter provisions in some jurisdictions allow the parties to the agreement to keep it secret.

⁴⁶ Ventrizzo (n 2) 425 notes that shareholder agreements in many cases can be kept confidential.

⁴⁷ Ventrizzo (n 2) 425.

⁴⁸ Takeover directive, art 9 if implemented mandates such a general meeting.

bid. They can also be exercised after a takeover where the successful bidder has purchased a majority of the cash-flow rights. This could result in a situation where a successful bidder does not acquire control over the company and allowing the old controlling shareholder to retain control.

1.3 The takeover directive

The market for corporate control, of which takeovers is a part, within the EU is a matter for national regulation. These national rules are on the other hand influenced by the takeover directive which aims to partly harmonize the rules regulating the market for corporate takeovers within the EU.⁴⁹ The directive contains several key elements which can be summarized as follows:

- Equal treatment of shareholders (article 5)
- Demands on the information provided to shareholders and public disclosure (article 6 and 8)
- Demands on the time given to shareholders to evaluate a bid (article 7)
- Limits to the actions of the board of the target company (article 9)
- The breakthrough rules (article 11)
- The right for companies to implement the breakthrough rules in the corporate charter in those cases that member states choose to opt-out of the rules (article 12)
- The right of squeeze-out and buyout (article 15 and 16)

The breakthrough rules of article 11 are directly connected with the questions of controlling shareholders and their ability to maintain control over a corporation without investing a matching amount of capital by setting aside charter provisions and shareholder agreements. They do so by nullifying any provisions restricting the free transfer of shares, equalizing

⁴⁹ The primacy of EU-law over national law was established by the CJEU in the cases 26/62 NV Algemene Transport- en Expeditie Onderneming van Gend & Loos v Netherlands Inland Revenue Administration. ECR 2 and 6/64 Flaminio Costa v E.N.E.L. (1964) ECR 587.

voting rights and giving the successful bidder who has acquired at least 75% of the shares the ability to swiftly call a general meeting where any such provisions are also set aside and during which the corporate charter can be altered.⁵⁰ They do not, however, affect the functioning of pyramids or cross holdings.⁵¹

When adopting the takeover directive, the EU made the implementation of the breakthrough rules optional and only a small number of countries have chosen to implement them.⁵² In those cases where a member state has chosen not to implement the rules it must however allow companies to do so through the corporate charter.⁵³ This begs the question under what circumstances implementing the rules is advantageous, either for a member state through legislation or for an individual company through its charter.

1.4 Perspective

Having raised the question of under which circumstances it is advantageous for a member state to implement the breakthrough rules the question of perspective will be addressed. Put simply, for whom would it be advantageous to implement the breakthrough rules? Possible perspectives could conceivably include for example controlling shareholders, minority shareholders, employees, creditors, and tax-payers.

The answer to this question is taken to be intimately connected to the role of corporate law. Pre-empting the discussion in the next section the choice is made to study the question from the perspective of society as a whole, striving to maximize the utility to the entire society from the use of the

⁵⁰ Takeover directive, art 11 paragraphs 2-4.

⁵¹ Pandit (n 1) 52-53; Bebchuk and Hart (n 27) 1-2.

⁵² Takeover directive, art 12 states the possibility for member states to opt out of the breakthrough rules. Regarding the number of countries adopting the breakthrough rules see European Commission, *REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS, Application of Directive 2004/25/EC on takeover bids* (2012) 4 and 8. At the time (2012) 3 member states had adopted the rules.

⁵³ Takeover directive art 12.

corporate form. This choice is made in order to achieve a congruence with the perceived role of corporate law.⁵⁴

1.5 The role of corporate law

Systematically, rules for corporate takeovers could be considered part of corporate law since it concerns the ownership of companies. It could also be considered part of contract law since it may be taken to concern contractual relationships between shareholders. However, as we shall see one way of analysing the competing interests of controlling and minority shareholders is through the lens of agency theory.⁵⁵

Corporate law is to a large extent focused on handling the inevitable conflicts of interest that arise between different stakeholders that exist within the corporate form.⁵⁶ One common way of the analysing these conflicts within the scope of corporate law is through the use of agency theory.⁵⁷ This means that there is an overlap between takeover regulations and corporate law concerning the type of conflict being studied and the possibility of using agency theory as a basis for the analysis.⁵⁸ For this reason a choice is made to treat takeover regulations a part of the wider sphere of corporate law in this thesis. This choice is echoed by Cahn and Donald who discuss the regulation of corporate takeovers in conjunction with company law.⁵⁹

⁵⁴ John Armour, Henry Hansmann, Reinier Kraakman and Mariana Pargendler, What is Corporate Law? in Reinier H. Kraakman (ed), *The anatomy of corporate law: a comparative and functional approach* (Third edn, Oxford, 2017) 22-24 discusses the role of corporate law.

⁵⁵ Text to n 125.

⁵⁶ Enriquez et. al. (n 22) 50 places this as one of the two main functions of corporate law.

⁵⁷ Armour et. al. (n 54) 29-31.

⁵⁸ Armour et. al. (n 54) 29-31 discusses the agency conflict inherent in the corporate form. The takeover directive addresses both the conflict between shareholders and management (through the no frustration rule in article 9) as well as that between controlling and minority shareholders (for example through the mandatory bid rule in article 5 and the breakthrough rules in article 11).

⁵⁹ Andreas Cahn and David C. Donald, *Comparative company law: text and cases on the laws governing corporations in Germany, the UK and the USA* (Cambridge University Press, Cambridge, 2010) p. 756f.

The role of corporate law is to be efficient in the sense of minimizing these agency costs thus maximizing the utility to be gained from using the corporate form.⁶⁰ In this case efficiency is measured on a societal scale and expressed in terms of economic efficiency.⁶¹ This focus on economic efficiency and in the case of the takeover directive on the relationship between different shareholders does not imply that other stakeholders are unimportant but that their interests are taken to be better protected through other avenues, for example in the case of employees through provisions of labour law.⁶²

How this efficiency is to be measured is another question with differing proposed answers. One commonly used metric is shareholder value even though this is not without its critics.⁶³ Having noted that the role of corporate law is to promote economic efficiency the question at the end of section 1.2; the question when it is advantageous for a member state or individual company to adopt the breakthrough rules can be rephrased once again to, when it is economically efficient to do so. In other words, under what circumstances are they economically efficient?

1.6 Purpose of the thesis

Having said this, we are now in a position to state the purpose of this thesis. Being clear over the fact that we are studying the breakthrough rules of the take-over directive and having assumed that the role of corporate law is to promote economically efficient solutions the purpose of the thesis can be stated as:

To evaluate the breakthrough rules of the takeover directive examining under what circumstances it is advantageous for a country to adopt them or for a corporation to adopt them voluntarily.

⁶⁰ Armour et. al. (n 54) 22-23.

⁶¹ Armour et. al. (n 54) 22-23.

⁶² Armour et. al. (n 54) 23.

⁶³ Armour et. al. (n 54) 23.

1.7 Research questions

The purpose of the thesis is fulfilled by answering a set of specific research questions and using these answers to perform an analysis to fulfil the purpose. The research questions provide the necessary background for the analysis. These questions concern the nature of economic efficiency, the breakthrough rules themselves and the economic background against which they may be applied. The research questions are:

- (1) When and how is it economically efficient to regulate corporate takeovers?
- (2) What are the ownership structures and attendant agency conflicts against which the effectiveness must be measured?
- (3) How should the breakthrough rules be interpreted legally?

These three questions then provide the necessary background for the final analysis which fulfils the purpose of the thesis.

1.8 Justification of research

At the moment, few member states have made the breakthrough rules mandatory through national corporate law.⁶⁴ Italy at first chose to implement them and previously had a variation on the theme of breakthrough rules before the takeover directive set out to harmonize the regulation of corporate takeovers in the EU.⁶⁵ This was changed under the Berlusconi government so that at the present date the breakthrough rule is a non-mandatory possibility for Italian companies that can be implemented through the corporate charter.⁶⁶ Against this background it could be felt that

⁶⁴ European Commission (n 52) 4 and 8. At the time (2012) 3 member states had adopted the rules.

⁶⁵ Jonathan Mukwiri, *Takeovers and the European Legal Framework A British Perspective* (Routledge-Cavendish, London and New York, 2009) 115; Cleary Gottlieb, *Implementation of the Takeover Directive in Italy (2008)* 3 mention Italy at first having opted to implement the breakthrough rules; Cleary Gottlieb 3 note 8 discusses the earlier Italian rule of a breakthrough character.

⁶⁶ Pavesio E Associato, *Italy takeover Guide* (2013) 19-20; Stefano Cachi Pessani and Bonelli Erede and Olivier Assant and Bredin Prat and Bernard Roelvink and De Brauw and Oliver Rieckers and Hengeler Mueller and Chris McGaffin and Slaughter and May and

it is of little interest to discuss their implementation against the background of the apparent non-interest shown by the majority of the member states.

This seeming non-interest does not however preclude that there can be a justification for studying a matter from a perspective of economic efficiency. Especially since the decision is not simply one that concerns the member states. In fact, the directive requires that individual companies be given the option to implement the breakthrough rules through the corporate charter.⁶⁷

A reasoned decision in the individual case requires that an analysis of possible advantages and disadvantages be made in each individual case. While much of the earlier research has been focused on the national level and the desirability of making the breakthrough rules mandatory for all companies in a jurisdiction this thesis strives to add to the understanding of the effects of the breakthrough rules both on a national level and on a company level and thus provide some insight into how the question can be analysed. A special effort is made to add to the understanding of the potential effects of the breakthrough rules in conjunction with Initial Public Offers (IPO) where a company turns to the broader public in order to seek finance for the first time.

1.9 Prior research

Questioning whether or not to implement the breakthrough rules in national law is not unique for this thesis. Martynova and Rennebog express a negative view of implementing the rules and with reference to Bebchuk and Hart express a fear that implementing the rules would lead to controlling

Gabriel Núñez and Uría Menéndez, *Guide to public takeovers in Europe* (2016) 390 and Ventoruzzo (n 2) 566-567; Guido Ferrarini and Geoffrey P. Miller, *A Simple Theory of Takeover Regulation in the United States and Europe* (42 Cornell Int'l L.J. 2009) 193 notes the reversal of Italian policy under the Berlusconi administration.

⁶⁷ Takeover directive art 12 paragraph 2 grants this right to companies in member states that have not adopted the breakthrough rules as mandatory.

shareholders instead adopting techniques that are not touched by them.⁶⁸ Bebchuk and Hart express the view that the net result of the implantation of the rules would be to increase the role of pyramid control structures.⁶⁹ Blanaid and Clarke point out that the provisions of the breakthrough rules allowing a successful bidder to breakthrough existing control mechanisms at a general meeting after the takeover can be easily bypassed by the controlling owner increasing its stake to slightly more than 25 percent or by moving the company outside the EU.⁷⁰

Berglöf and Burkart hold a more positive view of the breakthrough rules going as far as to argue that under some conditions the breakthrough rules will in theory lead to efficient control allocation by allowing value-adding takeovers and only value-adding takeovers to move forward.⁷¹ Their endorsement of the breakthrough rule is however not unconditional and they like Bebchuk and Hart point out the possibility that controlling shareholders who are faced with the breakthrough rules might well choose other control mechanisms to retain their controlling position, for example pyramid structures.⁷²

Berglöf and Burkart are prepared to accept the breakthrough rules from at least a theoretical point of view, at least in those cases where the controlling shareholder is in the financial position to make a counterbid.⁷³ They however, seem to constitute a minority opinion as evidenced by Blanaid and Clarke whose list of critics of the breakthrough rules is long and varied.⁷⁴

⁶⁸ Marina Martynova and Luc Renneboog, *Takeover Regulation* in H. Kent Baker and Halil Kiyamaz, Halil (eds.), *The art of capital restructuring: creating shareholder value through mergers and acquisitions* (Wiley, Hoboken, N.J., 2011) 52-53.

⁶⁹ Bebchuk and Hart (n 27) 1-2.

⁷⁰ Blanaid Clarke, *Takeover Regulation - Through the Regulatory Looking Glass* (8 German L.J. 381, 412, 2007) 397.

⁷¹ Erik Berglöf and Mike Burkart, *European Takeover Regulation* (18 ECONOMIC POLICY 171, 2003) 199f which includes a more formal justification based on security yield and the value of private benefits of control.

⁷² Berglöf and Burkart (n 71) 202.

⁷³ Berglöf and Burkart (n 71) 199.

⁷⁴ Clarke (n 70) 397 notes 55 and 56 where critics of the breakthrough rules are listed in the voluminous note 56.

On balance, the stance of much of the academic community seems to be at least sceptical of implementing the breakthrough rules.

Noting that few countries have adopted the rules to date the political reception of the breakthrough rules has not been overwhelming.⁷⁵ Without carrying out a comparative analysis of national law it can be noted that few countries have adopted the rules to date. No attempt has been made to investigate to which degree companies in countries that have not implemented the breakthrough rules have chosen to do so voluntarily.

1.10 Outline

The thesis consists of 4 parts aside from this introduction. Chapter 2 discusses the methodology. Thereafter three chapters discuss the economic and legal theory used in the analysis. These chapters answer the three research questions. In chapter three economic theory is used to define a measure of efficiency which can be applied. In chapter four the diverse economic realities which the analysis must handle are discussed and in chapter five the breakthrough rules are analysed. In the third section the question of when it is advantageous to adopt the breakthrough rules is analysed in chapter six. Finally, chapter seven concludes the thesis by drawing conclusions from the preceding analysis thus fulfilling the purpose of the thesis.

⁷⁵ European Commission (n 50) 4 and 8. At the time (2012) 3 member states had adopted the rules.

2 Methodology

A multi-pronged approach to the methodology of the thesis is described.

First a three-step test to define under what circumstances the breakthrough rules are advantageous, thereafter it is discussed how to isolate the different methods of exerting control used by controlling shareholders and how to interpret the legal rules of the takeover directive. Finally, it is discussed how the analysis fulfilling the purpose of the thesis is to be carried out.

2.1 Introduction

It was stated in the introduction that an economic perspective is to be used in evaluating the breakthrough rules.⁷⁶ This implies using theories from a discipline outside the strictly legal science to investigate a set of legal rules, in this case economic theory.⁷⁷ This foray outside of the strictly legal science into the realms of economics in the form of the discipline of law and economics has become common over the last few decades.⁷⁸ Even if the use of an economic analysis in a legal setting has become quite widely accepted there exist differing schools of thought regarding how such an analysis should be carried out.⁷⁹ This chapter sets out the methodology to be used when analysing under what circumstances it is advantageous to implement the breakthrough rules.

Referring back to the research questions of the thesis, these touched upon several items of a diverse nature.⁸⁰ They covered questions of economic efficiency, finance and how to interpret EU-law. Theories that can be used to analyse these questions must be found and assessed. Finally, a structured

⁷⁶ Text to n 54.

⁷⁷ Francesco Parisi, *Positive, Normative and Functional Schools in Law and Economics* (European Journal of Law and Economics, Vol. 18, No. 3, pp. 259-272, December 2004, George Mason Law & Economics Research Paper No. 04-22) 2-3; Vladimir Bastidas Venegas, *Rättsekonomi* in Fredric Korling and Mauro Zamboni, Mauro (eds.), *Juridisk metodlära* (Studentlitteratur, Lund 2013) 175.

⁷⁸ Parisi (n 77) 2-3

⁷⁹ Parisi (n 77) 8.

⁸⁰ Text before that to n 64.

approach to the final analysis is required. This indicates that a multi-pronged methodological approach which can address these different areas is necessary. Notwithstanding this, the thesis is firmly rooted in the methodology of law and economics. Therefore, it is desirable to begin by positioning the thesis within this field as utilizing either a positive, normative or functional approach to the subject.⁸¹

2.2 Choosing a normative approach

Paccès and Visscher state that a positive analysis aims to predict the consequences of legal rules.⁸² Parisi links the positive school of thought to scholars such as Posner and to the hypothesis that common law better than legislation can further the efficient functioning of society.⁸³ A normative analysis on the other hand aims to make policy recommendations and suggest advantageous legal rules.⁸⁴ Parisi notes that that the normative approach tends to see a greater role for legal intervention than the positive approach.⁸⁵

Paccès and Visscher question a complete division between positive and normative aspects of law and economics, noting that a positive analysis may well contain normative aspects and vice versa.⁸⁶ Parisi states that a third approach, the functional approach combines elements of both approaches and combines them with public choice theory to form a third and separate approach to examining the legal system using economic tools.⁸⁷

The purpose of the thesis has predominantly normative aspects since its purpose is to make recommendations on whether or not to adopt the

⁸¹ Parisi (n 77) 8-11 contains an overview of these different approaches to law and economics.

⁸² Alessio M. Paccès, and Louis T. Visscher, *Methodology of Law and Economics* (Bart van Klink and Sanne Taekema (Eds.), *Law and Method. Interdisciplinary research into Law* (Series Politika, nr 4, Tübingen: Mohr Siebeck 2011, pp. 85-107) 4.

⁸³ Parisi (n 77) 9.

⁸⁴ Paccès and Visscher (n 82) 4 and Parisi (n 77) 10.

⁸⁵ Parisi (n 77) 10.

⁸⁶ Paccès and Visscher (n 82) 4.

⁸⁷ Parisi (n 77) 10.

breakthrough rules.⁸⁸ At the same time making policy recommendations necessarily entail understanding their consequences, bordering on a positive analysis. The choice is made to utilize a normative approach based on the fact that the purpose of the thesis is to discuss the desirability of introducing the breakthrough rules, in other words making policy recommendations.

2.3 The economic methodology

Having chosen a normative approach to the subject it is now possible to discuss what this entails and the detailed methodology to be used. Paces and Visscher summarize the normative approach to law and economics as follows:

“Normative law and economics is carried out as follows. Law is analysed from an economic perspective, which, in the mainstream law and economics, is the rational choice theory. Policy recommendations are derived on the basis of economic analysis. In order to be able to provide such recommendations, it is necessary to develop a framework for assessing the relative desirability of different outcomes.”⁸⁹

For the present purpose, the framework must be able to answer the question whether or not it is advantageous to implement the breakthrough rules in a particular case. This entails ranking the two alternatives which are to either implement the breakthrough rules or to leave the matter unregulated. This would leave the matter to the market for corporate control as perfect or imperfectly functioning as it may be. From the role of corporate law, we know that we are to recommend the alternative that is more efficient.⁹⁰ The framework must therefore be able to discern the most efficient alternative.

A basic assumption guiding the field of law and economics is the assumption that parties to the transactions are rational maximizers meaning that they strive to maximize their personal gain from any transaction based on rational behaviour.⁹¹ The question of what they are maximizing, utility or

⁸⁸ Section 1.6 states the purpose of the thesis

⁸⁹ Paces and Visscher (n 82) 4.

⁹⁰ Armour et. al. (n 54) 22-23.

⁹¹ Parisi (n 77) 5.

wealth is discussed in a later section and it is assumed that wealth or money in the form of share value is to be used as at least a proxy of what the actors are maximizing for the purposes of this thesis.⁹² Either they are maximizing utility or wealth we must therefore assume that the actors involved in a takeover bid will act so that their personal utility or wealth is maximized. Should this lead to a suboptimal solution on a societal scale the task of creating a situation where this also leads to societal efficiency is left to corporate law.

Pacces' and Visscher's article on the methodology of law and economics is taken as a starting point for both this section on methodology and when the framework is constructed in chapter 3. This is based on the fact that its extensive references and bibliography allow a quick reference to the concept of economic efficiency as used in law and economics.⁹³ Their text above all touches on questions of what constitutes efficiency. To this is added the question if it can be expected that a proposed and theoretically effective rule can be expected to fulfil its purpose in practice.⁹⁴

The framework is constructed in the next chapter and consists of a three-part test, the first two questions of which are more theoretical and concern the need for rulemaking and what constitutes efficiency in regard to takeover bids. The first question concerning the need for intervention in the market takes as its starting points agency theory and Gilson's view that controlling shareholders are not per definition a bad thing. Working from these, indicators are found that imply a risk that the market would arrive at non-optimal solutions.

For the second test, that of theoretical suitability the starting point is the theoretical model used by Berglöf and Burkart. They state that some takeovers are value-adding and thus desirable from a viewpoint of

⁹² Text to n 115 and 116.

⁹³ Pacces and Visscher (n 82) 14-16 contains an extensive bibliography.

⁹⁴ This is based not the least on the discrepancy between the theoretical model constructed by Berglöf and Burkart which shows that in theory the breakthrough rules will give an optimal solution and the scepticism shown by Bebchuk and Hart over the likelihood that this would be the case in reality.

efficiency.⁹⁵ The existence of private benefits of control are an important factor in their analysis and affects the price required for a controlling shareholder to be willing to sell their stake in a company.⁹⁶ The test that is devised based on their theoretical understanding strives to identify situations where a controlling shareholder would rationally block an otherwise value-adding takeover bid thus potentially allowing the breakthrough rules to increase the efficiency of the market for corporate control by allowing these value-adding transactions to go forward in spite of the existence of controlling shareholders.

The final test strives to identify situations where the breakthrough rules although in theory efficient would not have the desired effect in practice. This is done by noting situations where scholars have argued that this would be the case and discussing whether or not the studied situation is one of these.⁹⁷

2.4 The economic background

Since the main thrust of the thesis is to evaluate under what circumstances the breakthrough rules have potential to be effective it is necessary to explore the differing conditions under which they may operate. Since the focus is not on a comparative analysis it is not necessary to examine in detail the actual conditions in member states, a more general outline of reported circumstances is sufficient especially since countries are not monolithic, situations vary between companies within the same country.⁹⁸

A general search of academic articles concerning methods for separating control rights from cash-flow rights is conducted. This gives an overview of the theoretically available methods and an indication of their prevalence

⁹⁵ Berglöf and Burkart (n 71) 197 and 199.

⁹⁶ Berglöf and Burkart (n 71) 199.

⁹⁷ Bebchuk and Hart (n 27) 1-2 for example note situations where they mean that the breakthrough rules might even be counterproductive by pushing controlling shareholders into other control mechanisms.

⁹⁸ Gilson (n 16) 1645-1647 contains a short overview of variations between selected countries but also shows that in no case is the situation within a particular country monolithic.

within the member states of the EU. Against the background of the increased use of control mechanisms in conjunction with initial public offerings reported from the US an extra effort is made to survey this situation.⁹⁹

2.5 The legal methodology

Having discussed how to construct the framework to test the breakthrough rules against differing strategies for a controlling shareholder to retain control a thorough understanding of the rules themselves is necessary. Interpreting the rules is a question for not economic theory but legal methodology. This section lays out the basic methodology used to interpret EU-legislation and the interpretation itself is found in chapter five.

The takeover directive is not immediately applicable but is instead implemented in national law.¹⁰⁰ While transposing the directive to national law the member states are expected to be loyal to the EU and the purpose of the legislation being implemented.¹⁰¹ Furthermore, when faced with a conflict between national law and the requirements of the underlying EU-legislation it has long been the clear policy of the Court of Justice of the European Union (CJEU) that EU-law as interpreted by the CJEU has primacy over national law.¹⁰² National courts are expected to interpret national law in such a way as to create the greatest possible compliance with the underlying EU-legislation.¹⁰³

Since this thesis is concerned with the more abstract possibility of implementing the breakthrough rules than any specific implementation of them it is possible to look only at the rules as they are written in the directive and interpret them using methods appropriate for interpreting EU-

⁹⁹ Lin (n 18) 462.

¹⁰⁰ Takeover directive art 21.

¹⁰¹ Treaty on the European Union art 4.3.

¹⁰² The primacy of EU law was first articulated by the CJEU in the case 6/64 *Flaminio Costa v E.N.E.L.* (1964) ECR 587.

¹⁰³ 14/83 *Sabine von Colson and Elisabeth Kamann v Land Nordrhein-Westfalen* (1984) ECR 1892 where the CJEU laid down this principle.

legislation. The directive is part of the legal system of the EU which forms a separate legal system from that of the member states.¹⁰⁴ The method of interpretation is also separate from that of the member states and not dependant on that of any particular member state.¹⁰⁵

The CJEU is commonly held to use a teleological method in those cases where a textual interpretation of legislation is not sufficient.¹⁰⁶ This implies interpreting the legislation in the way that helps achieve the goals of the legislation and the union the most.¹⁰⁷ One goal apart from the basic goals of the treaties that has according to this view consistently been given a high priority by the CJEU is furthering the integration of the union.¹⁰⁸ The debate is not so much over if the CJEU has used a teleological approach so much as to whether or not it still does so.¹⁰⁹ This debate is at the same time tempered by the fact that as the legal system of the EU has evolved there are fewer gaps available to be filled by products of teleological interpretation, it may be that the court still uses a teleological method in uncertain cases but there are fewer such cases.¹¹⁰ For this thesis it will be assumed that this is the case and that a teleological method is appropriate.

Case law is in no sense unimportant when interpreting EU-legislation since the CJEU is the final interpreter of EU-legislation. However, the court itself is by some considered to be less than stringent in its handling of earlier case law complicating the task of interpretation.¹¹¹ The absence of case law with

¹⁰⁴ Jane Reichel, *EU-rättslig metod* in Fredric Korling and Mauro Zamboni, Mauro (eds.), *Juridisk metodlära* (Studentlitteratur, Lund 2013)109 with reference to the case 26/62 NV Algemene Transport- en Expeditie Onderneming van Gend & Loos v Netherlands Inland Revenue Administration. ECR 2

¹⁰⁵ Reichel (n 104) 109-110.

¹⁰⁶ Ulla Neergard and Ruth Nielsen, Where Did the Spirit and Its Friends Go? On the European Legal Method(s) and the Interpretational Style of the Court of Justice of the European Union in Ulla B. Neergard and Ruth Nielsen and Lynn M. Roseberry (ed.), *European legal method: paradoxes and revitalisation* (DJØF, Copenhagen, 2011) 109.

¹⁰⁷ Neergard and Nielsen (n 106) 110 citing judge Pescatore and 112-113 citing Maduro.

¹⁰⁸ Neergard and Nielsen (n 106) 114-115 and 127.

¹⁰⁹ Neergard and Nielsen (n 106) 127.

¹¹⁰ Neergard and Nielsen (n 106) 127.

¹¹¹ Neergard and Nielsen (n 106) 134.

regard to the breakthrough rules makes this issue a moot point which will not be further discussed.¹¹²

To summarize, should the need arise to interpret any part of the breakthrough rules a teleological approach is to be used in the absence of case law. If no other goals have been stated for the directive it is possible to argue that the interpretation should further the fundamental goals of the union and a closer integration.

2.6 The analysis

Varying control mechanisms and their implications are surveyed in chapter four. This creates a list of basic situations that are of interest. The items on this list are then tested using the framework from chapter three to identify the situations where the breakthrough rules are advantageous in the sense of creating efficient solutions not only in theory but also in reality. In this analysis, the breakthrough rules are used as they were interpreted in chapter five.

¹¹² Text to n 196 discusses the absence of case law from the CJEU.

3 Economic theory

A three-step test to determine if it is advantageous in a given situation to implement the breakthrough rules or not is developed. The three steps are a test of necessity, a test of theoretical suitability and finally a test of practical suitability. Only if a proposed implementation passes all three tests will it be considered advantageous to implement the breakthrough rules. The development of this test as the framework required in normative law and economics also answers the first research question.

3.1 Introduction

According to Paces and Visscher normative law and economics is characterized by using a framework to rank the available options according to their desirability.¹¹³ This chapter is devoted to creating the framework needed to analyse when it is advantageous to implement the breakthrough rules. This is done by combining existing theories articulated by different scholars that touch upon the different aspects of corporate takeovers. In many cases there exist competing views, for example not every scholar agrees that agency theory is the only or proper way to analyse the corporate form.¹¹⁴

In this case we are not faced with a series of options that need to be ranked. Instead we are faced with a number of different control mechanisms such as differentiated voting rights or cross-holdings. The task of the framework is therefore not to rank different alternatives in terms of desirability but instead to judge if the breakthrough rules have the potential to create an efficient situation under a given circumstance. To do this a framework will be constructed in the form of a test that given a specific ownership configuration tells us if the breakthrough rules are advantageous or not.

¹¹³ Paces and Visscher (n 82) 4.

¹¹⁴ Jensen and Meckling (n 15) 7-9 note the view of the firm as a nexus of contracts.

3.2 Made assumptions

It is not possible within the format of this thesis to discuss and defend every underlying assumption fully. The choice has instead been made to openly state certain assumptions that have been made:

- It is assumed that it is not efficient to regulate such situations where market mechanisms have already created a reasonably efficient solution.
- It is assumed that if a proposed regulation will likely not work in practice it should not be enacted.
- Based not least on the difficulty of performing interpersonal comparisons of utility it is assumed that efficiency will be measured by maximizing wealth.¹¹⁵
- It is assumed that share-value will be used if it is necessary to compare different levels of wealth. This is not inconsistent with the views of many scholars even if dissenting views exist.¹¹⁶

3.3 Outlining a three-step test

Earlier, the conclusion was drawn that a test was a suitable form for the framework that is at the heart of normative law and economics. This was based on the fact that the objective is not to rank different alternatives but instead to draw one of two possible conclusions. Either it is advantageous to implement the breakthrough rules in a given situation or it is not. This does not preclude the test from consisting of several steps where the proposed regulation has to pass all the steps in order for it to be advantageous.

¹¹⁵ Paces and Vischer (n 82) 6 contains a discussion on interpersonal comparisons.

¹¹⁶ Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices* (59 Stan. L. Rev. 2007) 1526ff regarding prioritizing shareholder value; Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law* (24 J. Corp. L. 1999) 751-752 take issue with the primacy of shareholder value.

Remembering that the role of corporate law is to promote efficiency in order to maximize utility on a societal level the overarching test is whether or not the breakthrough rules will cause economically efficient takeovers to move forward while not artificially favouring inefficient bids.¹¹⁷ It was assumed above that in those cases where the market is capable of arriving at efficient solutions without regulation it is best left unregulated. Based on this assumption a first sub-test is to question the necessity of implementing the breakthrough rules to begin with. Put in other words; is there something in the situation that would be affected by the breakthrough rules and that the market for corporate control is unable to handle.

If it is found that in a given situation the market for corporate control risks not arriving at an efficient end-state on its own the case for regulation passes the first test which will be called the test of necessity. In these cases, a second test will be applied. This test which will be called a test of theoretical suitability will test whether or not the breakthrough rules can in principle address the risk that the market-based solution will not be efficient. Should this not be the case the breakthrough rules serve little purpose in the specific case and fails the test of theoretical suitability.

Having established two tests, that of necessity and that of theoretical suitability, attention is now turned to reproducing the effects in practice. This choice is made against the backdrop of Bebchuk's and Harts' criticism of the breakthrough rules where they hypothesize that controlling shareholders may choose to change from for example differentiated voting rights which are affected by the breakthrough rules as a tactic for retaining control to for example utilizing a pyramid scheme which is not.

This third test, called a test of practical suitability tests whether or not the breakthrough rules are likely to have the desired theoretical effect in practice. This decision is made against the backdrop of the assumption that

¹¹⁷ Armour et. al. (n 54) 22-23 regarding the role of corporate law. Berglöf and Burkart (n 71) 197 and 199 on what constitutes efficient takeovers.

regulations which are not likely to have the desired effect in practice should not be implemented.

Having outlined a three-step test against which the breakthrough rules can be evaluated it is now time to discuss these factors in greater detail. This is done in three sections discussing the three parts of the test and finally a concluding section summarises the test that will be applied to the breakthrough rules.

3.4 Test 1; is it necessary

3.4.1 Introduction

The first test we wish to apply to the implementation of the breakthrough rules is a test of necessity. We want to know if it is really necessary to regulate the issue at hand or if the market can be left to handle the question. This section will not be an exhaustive evaluation of all possible reasons why the breakthrough rules may be needed, instead it will concentrate primarily on the implications of agency theory in situations with a non-majority controlling shareholder. This decision is based on the common use of agency theory in discussions regarding corporate law.¹¹⁸ Besides agency theory Gilson's view on beneficial and harmful controlling shareholders will be discussed since it to some extent balances the view inherent in agency theory that agency conflicts are inherently costly.¹¹⁹

3.4.2 Agency theory

Agency theory starts with the corporate form itself noting that within the corporation there are shareholders, management and other stakeholders.¹²⁰ It further notes that these groups may have different goals that can come into

¹¹⁸ Martin Gelter, *The Dark Side of Shareholder Influence: Toward a Holdup Theory of Stakeholders in Comparative Corporate Governance* (March 17, 2008 ECGI - Law Working Paper No. 096/2008; CLEA 2008 Meetings Paper; Harvard Olin Fellows' Discussion Paper No. 17/2008) 4 goes as far as calling the principle agent paradigm "The predominant academic view".

¹¹⁹ Jensen and Meckling (n 15) 5 note that "... there is good reason to believe that the agent will not always act in the best interests of the principal."

¹²⁰ Gelter (n 118) 4-5.

conflict with each other.¹²¹ For example, the lately discussed question of management compensation could be analysed from an agency perspective.¹²² Shareholders have a natural wish to maximize dividends while management has an equally natural wish to maximize their own compensation even at the expense of dividends.¹²³

The breakthrough rules concern the relationships between different shareholders. They do this by targeting control mechanisms employed by controlling shareholders.¹²⁴ For this reason, the agency conflict of greatest interest to this discussion is that between minority shareholders and controlling shareholders.

The minority shareholders are present as investors and their dominant interest in the company is to receive a return on investment, according to La Porta et. al. preferably in the form of dividends for reasons of the time-value of money even if a rise in share value is a possibility.¹²⁵ Dividends are paid from past and present profits while estimates of proper share value commonly takes in account all present and future disbursements, primarily dividends, from the company to the shareholders.¹²⁶ These disbursements stem from the profits of the company meaning that in both cases the investor as a residual claimant is dependent on profits for his or her return on investment.¹²⁷

A dominant shareholder on the other hand may have other interests besides that of making possible the largest possible dividends. This stems from the fact that a controlling owner, and management for that matter, may have the

¹²¹ Oliver Hart, *An Economist's Perspective on the Theory of the Firm* (89 Colum. L. Rev. 1989) 1758-1759.

¹²² Andrei Shleifer and Robert W. Vishny, *A Survey of Corporate Governance* (The Journal of Finance, Vol. LII, No. 2 June, 1997)744-745.

¹²³ Shleifer and Vishny (n 122) 740-741.

¹²⁴ Bebchuk and Hart (n 27) 1-2 while criticising the rules agree on the fact that they target a control mechanism. They primarily discuss dual-class shares with differential voting rights.

¹²⁵ Rafael La Porta and Florencio Lopez de Silanes and Andrei Shleifer and Robert W. Vishny, *Agency Problems and Dividend Policies Around the World* (June 1998 NBER Working Paper No. w6594) 4.

¹²⁶ Pablo Fernandez, *Company Valuation Methods* (October 11, 2017) 8.

¹²⁷ Fenandez (n 126) 11.

possibility to extract private benefits of control from the company.¹²⁸ These can take various forms, for example preferential pricing in relation to another company controlled by the same owner, but have the common characteristic that they do not benefit the all shareholders equally.¹²⁹

Any private benefits of control extracted by a controlling shareholder are paid for by all shareholders in relation to their share of cash-flow rights in the form of reduced dividends.¹³⁰ A controlling shareholder with small cash-flow rights can therefore in theory let the other shareholders subsidize his or her private benefits of control.¹³¹ This means that there can exist a divergence of interest between controlling and minority shareholders where the controlling shareholder is more interested in maximizing the private benefits of control than the profits.¹³²

The private benefits of control have a value to the controlling shareholder that added to the share value might exceed what a bidder is offering in a takeover bid.¹³³ Theoretically it is this value that provides an incentive for a large shareholder to accept the information-gathering costs inherent in exerting control over management.¹³⁴ Without being compensated through private benefits of control it would simply not be worth it for a large shareholder to discipline management.

A bidder is however, not allowed to offer the controlling shareholder a higher price than others.¹³⁵ The fact that all shareholders must be offered the same price in a takeover bid means that a controlling shareholder might turn down a takeover bid that is economically efficient by being value adding as insufficient since it does not compensate for the value of the lost private

¹²⁸ La Porta et. al. (n 125) 5-6.

¹²⁹ La Porta et. al. (n 125) 5-6.

¹³⁰ La Porta et. al. (n 125) 4; Bebchuk et. al. (n 4) 308-309.

¹³¹ Bebchuk et. al. (n 4) 308-309 This follows from the fact that private benefits of control reduce the profits and thereby the possible dividends equally in relation to the cash-flow rights but are only available to a subset of the shareholders.

¹³² Shleifer and Vishny (n 122) 758.

¹³³ Berglöf and Burkart (n 71) 199.

¹³⁴ Gilson (n 14) 1651

¹³⁵ Berglöf and Burkart (n 71) 197 discusses the mandatory bid rule of article 5 of the takeover directive.

benefits of control.¹³⁶ The controlling owner may also have the ability to not only turn down the offer regarding his or her shares but also to in practice affect any defensive measures taken by the company or to make a bid not worthwhile to the presumptive bidder even if he or she owns less than half the cash-flow rights.¹³⁷

This stems from the fact that for example differential voting rights may allow the incumbent controlling shareholder to retain control even after a successful takeover bid. This would in turn reduce any bidders interest in making a bid. The existence of controlling but non-majority shareholders is thus an indication that the market may not be able to handle takeovers in an economically efficient manner.

3.4.3 Controlling shareholders, not always harmful

Gilson holds the view that controlling shareholders and the extraction of private benefits of control are not intrinsically harmful.¹³⁸ He states that a controlling shareholder may serve to discipline management and that provided that the benefits being extracted are less than the efficiency gained from this, minority shareholders actually stand to win from the existence of a controlling shareholder.¹³⁹ The analysis that minority shareholders can stand to gain from the disciplining of management is echoed by Lin.¹⁴⁰

Gilson instead proposes that the question of whether the existence of a controlling shareholder is beneficial or not to the minority shareholders is instead tied to the question of good and bad law as well as the size of the private benefits of control being extracted.¹⁴¹ His conclusion is that under conditions of good law and low private benefits of control in many cases the

¹³⁶ Berglöf and Burkart (n 71) 197 and 199.

¹³⁷ Bebchuk et. al. (n 4) 295-296; Takeover directive, art 9 regarding defensive measures. Control rights in excess of cash-flow rights would give a controlling shareholder an increased voice at any general meeting called to discuss defensive measures.

¹³⁸ Gilson (n 16) 1651-1652.

¹³⁹ Gilson (n 16) 1651-1657.

¹⁴⁰ Lin (n 18) 472.

¹⁴¹ Gilson (n 16) 1653-1657.

minority shareholders stand to benefit from the existence of a controlling shareholder compared to a situation where no party is able to discipline management.¹⁴²

Translating this into a test for the necessity of regulating takeovers with regard to controlling shareholders we must therefore be observant of the two factors, bad law and the size of private benefits of control. While the first factor is country-specific the second factor may reasonably vary between companies within the same jurisdiction. Based on Gilson's reasoning, should both these factors be present it is a sign that the market may well be unable to arrive at an efficient solution on its own.

3.4.4 The test of necessity

The first test that a proposal to implement the breakthrough rules must pass if it is to be considered efficient is therefore the test of necessity. The situation must be such that the market is not likely to arrive at a satisfactory solution on its own. We have noted three different factors as important in indicating a need for regulation. These are:

- The existence of controlling non-majority shareholders
- The existence of bad law
- The size of private benefits of control commonly being extracted.

Should controlling shareholders be absent the other two factors have no independent function. They simply serve to strengthen the case for regulation in the presence of controlling shareholders.

3.5 Test 2, will it work in theory

3.5.1 Introduction

Having defined a test of necessity the discussion now turns to examining if a proposed implementation of the breakthrough rules has the theoretical

¹⁴² Gilson (n 16) 1653-1657.

ability to create an effective solution. In order to define the term effective, we borrow heavily from Berglöf's and Burkart's article on takeover regulation which contains a definition of which takeovers should be considered beneficial.¹⁴³

3.5.2 Berglöf and Burkart

Berglöf's and Burkart's model has the basic premise that those takeover bids that add value and only those bids are advantageous.¹⁴⁴ The two components that they assign to the value of a company are the return on investments which they term security yield and the private benefits of control that a controlling shareholder can extract.¹⁴⁵ They further posit that a takeover is value increasing if the sum of these components is greater after a successful bid than before.¹⁴⁶

Given a static condition it could be thought that the sums of security yield and private benefits of control would be equal, the target company has the same capability of generating a return on investment irrespective of ownership. A takeover situation is however dynamic in the sense that the new owners may have different priorities and capabilities. They may value the possibility to extract private benefits of control differently in a situation where they seek a controlling position or may have a greater ability to create a higher return on their investment.¹⁴⁷ For these reasons the value of the company may differ under different ownerships and there is scope for both value increasing and value decreasing takeover bids.

The reason that a controlling shareholder may decline a value-adding takeover bid is that the benefits of control are not evenly distributed, they are instead concentrated with the controlling shareholder.¹⁴⁸ This results in the average value per share to the controlling shareholder being higher than

¹⁴³ Berglöf and Burkart (n 71) 197 and 199.

¹⁴⁴ Berglöf and Burkart (n 71) 197 and 199.

¹⁴⁵ Berglöf and Burkart (n 71) 197.

¹⁴⁶ Berglöf and Burkart (n 71) 197.

¹⁴⁷ Berglöf and Burkart (n 71) 196.

¹⁴⁸ Berglöf and Burkart (n 71) 197 and 199.

the average value taken over all shares.¹⁴⁹ In extreme cases with a large imbalance between control power and cash-flow rights the difference can theoretically become large.¹⁵⁰

Should it be the case that the value to the controlling owner is higher than the average value per share offered by the rivalling bidder the controlling owner will decline to sell under the assumption that he is acting rationally.¹⁵¹ In such a situation a value adding transaction may well be blocked by the controlling owner, this case may in fact be exacerbated by the equitable price rule of the takeover directive which requires that a bidder offer all existing shareholders the same price, thus making it impossible to compensate only the incumbent controlling shareholder for his loss of private benefits of control.¹⁵²

The key to this question is the relationship between the value added by the takeover and the size of the private benefits of control in relation to the cash-flow rights owned by the incumbent controlling shareholder. The smaller the cash-flow rights owned by the existing controlling shareholder the greater the value of the private benefits of control as a percentage of the value of the security yield. This in turn requires a higher price from the bidder to lead to acceptance. Since the bidder is forced to offer all owners the same price this may lead to a situation where a successful bid would require a price higher than the value to the bidder even if the bidder were to be able to create a large added value.

Put in numbers this reasoning can be described in a simple example.

Suppose that the security yield of all shares is 1000 and that the present controlling shareholder extracts private benefits of control to the amount of

¹⁴⁹ Berglöf and Burkart (n 71) 197 and 199.

¹⁵⁰ Bebchuk et. al. (n 4) 298 where Bebchuk, Kraakman and Triantis reported that Investor who at the time (2000) owned 7 % of the cash-flow rights in Electrolux controlled 95 % of the votes is a historical example of a large imbalance between control rights and cash-flow rights.

¹⁵¹ Berglöf and Burkart (n 71) 197; Parisi (n 77) 5 notes that rational behaviour is assumed in law and economics. The equitable price rule is contained in article 5 of the takeover directive.

¹⁵² Berglöf and Burkart (n 71) 197.

100. Suppose further that the incumbent owns 25 percent of the cash flow rights. The sum total of the security yield and the value of the private benefits of control is 1100 before the bid and 350 of this value accrues to the controlling shareholder. If a potential bidder can add value worth at least 300 bringing the total value to 1400 and makes an offer at this level the controlling shareholder is offered 25 % of 1400 which is 350. At this level, continued ownership or selling carries the same value and considering the time-value of money it would be rational to sell.¹⁵³

Should the incumbent's percentage of cash-flow rights be as low as 10 % the situation becomes drastically different.¹⁵⁴ In this case the value to the incumbent is 200 but the bid must increase to at least 2000 for it to be rational for the controlling shareholder to accept the bid. It is vastly less likely that a potential bidder should be able to increase the value by 81 % than by 27% and be able to create a bid that will be accepted by the incumbent controlling shareholder. The takeover which would clearly add value will therefore probably not take place.

Thus, the likelihood of a controlling shareholder blocking a value-adding takeover bid is to a large extent dependant on two factors. These are the size of the private benefits of control and the degree of difference between control rights and cash-flow rights. The breakthrough rules are theoretically effective in both these cases by aligning the control and cash-flow rights more closely to each other in those cases where the control mechanisms used by the controlling shareholder are affected by the breakthrough rules.

As Bebchuk and Hart point out not all control mechanisms are affected by the breakthrough rules.¹⁵⁵ In those cases, for example pyramids, that are unaffected, the breakthrough rules cannot be effective from a theoretical point of view since they do not have the ability in these cases to realign

¹⁵³ La Porta et. al. (n 125) touches upon the time value of money.

¹⁵⁴ Bebchuk et. al. (n 4) 298 where Bebchuk, Kraakman and Triantis reported that Investor who at the time (2000) owned 7 % of the cash-flow rights in Electrolux controlled 95 % of the votes show that the example is not historically as far-fetched as it may seem at first glance.

¹⁵⁵ Bebchuk and Hart (n 27) 1-2.

control rights with cash-flow rights. In these cases, there is no point in implementing the breakthrough rules.

3.5.3 The test of theoretical suitability

The second test is one of theoretical suitability. It tests whether or not the breakthrough rules are in theory capable of creating an effective solution in a certain situation. The key points to look out for are the degree of separation of control rights from cash-flow rights and the ability of the breakthrough rules to affect this. If there is large degree of separation of control rights from cash-flow rights, especially combined with a potential for the extraction of large private benefits of control and the breakthrough rules are able to realign the control rights with the cash-flow rights they are theoretically efficient.

3.6 Test 3, can it be circumvented

3.6.1 Introduction

Should it be found that a proposed implementation of the breakthrough rules would indeed be necessary in the light of the fact that the market is unable to arrive at an efficient solution unaided and that the rules can theoretically achieve an efficient outcome we arrive at the final test, that of practical suitability. It is assumed that there is no point in choosing to implement the rules if it is possible for example for a controlling shareholder to bypass them or if some other practical consideration makes it unlikely that they will be effective.

The effects of the need to pay compensation to the controlling shareholder will be explored separately. Should the requirement to pay compensation render a takeover bid prohibitively expensive it can be called into question if the rules are suitable in practice. This will be discussed after the main analysis when conclusions are drawn.

3.6.2 Evasion of the rules

Bebchuk and Hart note that there are control mechanisms such as pyramids that are not affected by the breakthrough rules and which can be used to evade the breakthrough rules.¹⁵⁶ One part of this test must therefore clearly be to discuss the possibility of evading an implementation of the breakthrough rules by switching to another method for separating control rights from cash-flow rights.

Should it be found that it is in practice possible to evade the breakthrough rules by switching to another control mechanism they will have little or no effect. In such a case, a proposal to implement the rules fails the test of practical suitability.

3.6.3 The test of practical suitability

This third and final test aims to find in which cases implementing the breakthrough rules will not have the desired result in practice even though it should theoretically do so. It does so by posing the following question:

- Is it difficult or prohibitively costly to evade the effect of the breakthrough rules for the controlling shareholder?

The breakthrough rules are only efficient in practice as well as in theory if the answer to this question is yes.

3.6.4 The effects of paying compensation

The breakthrough rules do not simply strip the controlling shareholder of its rights, they also promise equitable compensation for any losses incurred by the breakthrough directive.¹⁵⁷ This potential cost must be added to the bid price that must be offered to the existing shareholders for the bid to be accepted by a potential bidder. This can in principle lead to one of two different situations; either the bidder is forced to first pay a price high

¹⁵⁶ Bebchuk and Hart (n 27) 1-2.

¹⁵⁷ Takeover directive art 11 paragraph 5.

enough to entice the controlling shareholder to accept the bid despite the value of the private benefits of control and then pay compensation or the controlling shareholder will accept a lower bid knowing that he will be compensated for the loss of private benefits of control.

In practice, the presence of the compensation rule injects an element of uncertainty into the takeover bid process. It is not possible to know precisely beforehand if and how much compensation will have to be paid.¹⁵⁸ This uncertainty may in practice threaten takeover bids, especially those with some but not large capacity to add value since the bidder must make allowance for the risk of having to pay compensation. The greater this uncertainty is the more takeover bids will be affected.

The effects of the requirement to pay compensation to the controlling shareholder who is deprived of rights under the breakthrough rules could in many ways be part of the third test, that of practical suitability. A choice has however been made to separate them from this test and discuss them in the final chapter when conclusions are drawn.

3.7 The three-step test

This chapter has set out a three-step test to be applied to the breakthrough rules. Should any of the tests fail it is doubtful that implementing the breakthrough rules will be advantageous, either for a member state or for an individual company. The test can be applied in sequence but should it be obvious that a particular situation will fail a later test the earlier tests can be skipped and that test applied directly. The three tests can be summarized as:

- The test of necessity. Are controlling shareholders with greater control rights than cash-flow rights present? Are there signs of bad law or the extraction of large private benefits of control?
- The test of theoretical suitability. Is there a large degree of separation between control rights and cash-flow rights? Is there a

¹⁵⁸ Text to 213 and 214.

potential to extract large private benefits of control? Are the enhanced control rights affected by the breakthrough rules?

- The test of practical suitability. Is it difficult or costly to evade the rules?

Only if the answer to all these questions is yes can it be considered advantageous to implement the breakthrough rules. In the final chapter the conclusions are affected by the requirement to pay compensation.

4 The economic background

A number of situations where concentrated ownership may separate control rights and cash-flow rights are studied. These include mechanisms such as differential voting rights, pyramids and shareholder agreements. Their effects on the takeover situation are discussed. The case of IPO:s where founding owners wish to retain control rights in excess of their new cash-flow rights is discussed separately. This chapter answers the second research question.

4.1 Introduction

We have previously touched upon the fact that different ownership structures may have implications regarding the agency conflicts inherent in the corporate form. In the case of dispersed ownership, the conflict between shareholders and management will become dominant while in the case of a controlling shareholder who is extracting private benefits of control, the conflict between the controlling and minority shareholders will dominate.¹⁵⁹ This chapter explores a number of different ownership and control structures and the conflicts inherent in them.

The chapter makes no pretence at being exhaustive in its exploration, merely to cover a number of key points. The basic distinctions that will be studied are the degree of concentration of ownership, differential voting rights, shareholder agreements, constructions such as pyramids and crossholdings, and initial public offers.

4.2 Concentration of ownership

Traditionally the US and the UK have been taken to represent the case of dispersed ownership where no one shareholder has the power to exert control over management.¹⁶⁰ On the other hand continental Europe has been

¹⁵⁹ La Porta et. al. (n 125) 5-7.

¹⁶⁰ Gilson (n 16) 1645.

taken to represent economies dominated by controlling shareholders even if this does not mean that every company in these countries has or has had one.¹⁶¹

In the case of dispersed ownership, the main agency conflict is between shareholders as a group and management who as insiders are capable of extracting private benefits of control if not disciplined.¹⁶² This has implications in the case of takeover bids where management may seek to block takeover bids that are advantageous to shareholders as a group for reasons of their own.¹⁶³

In the case of concentrated ownership, the potential conflict between management and shareholders as a group is reduced due to the ability of the controlling shareholder to discipline the management team.¹⁶⁴ On the other hand the controlling shareholder has the ability to extract private benefits of control and as discussed earlier this comes at the possible expense of the minority shareholders.¹⁶⁵

Controlling shareholders may hold either an outright majority in terms of cash-flow rights or a controlling but non-majority position.¹⁶⁶ The effects of control through a majority position is to give outright control but at the same time aligning control rights and cash-flow rights meaning that the majority owner pays for a large part of any private benefits of control extracted. In the absence of any special provisions such as golden shares the majority owner cannot normally be compelled to give up his controlling position and is thus free to resist a takeover bid.

The non-majority controlling shareholder on the other hand has to some degree separated control rights and cash-flow rights. This can be either through a control enhancing mechanism or the rational apathy of the

¹⁶¹ Gilson (n 16) 1645-1647.

¹⁶² La Porta et. al. (n 125) 5-6.

¹⁶³ Shleifer and Vishny (n 122) 747

¹⁶⁴ Gilson (n 16) 1651.

¹⁶⁵ Gilson (n 16) 1651.

¹⁶⁶ Shleifer and Vishny (n 122) 755.

minority shareholders.¹⁶⁷ The possibility of extracting private benefits of control while being necessary to induce the controlling shareholder to undertake to discipline management increases the incentive to block a value adding takeover bid for rational reasons.¹⁶⁸

4.3 The role of banks and the state

This section examines two special types of shareholders, banks and states. In for example Germany, it is not uncommon for banks to directly own blocks of shares in major corporations or to exercise influence over corporate decisions.¹⁶⁹ This has the potential of creating a conflict between the bank in its role as an investor and as a lender.¹⁷⁰ This is based on the fact that an investor normally has a greater appetite for risk than a lender.¹⁷¹ In these cases where banks take on both roles there is a perceived risk that the banks' management will prioritize their responsibility towards their own shareholders, thus taking lesser risks than would be optimal for the other investors in the corporation in which the bank owns a stake.¹⁷²

The other special case is when the state owns control rights in listed corporations with the attendant potential to affect corporate decisions. Parallel to the discussion concerning banks owning large stakes this is also perceived to risk a conflict of interest. In this case this would be based on the risk that decisions by the state may be based on other, political or bureaucratic parameters than those of the other investors which could lead to a lower rate of return on the investment to the detriment of minority shareholders.¹⁷³

¹⁶⁷ Bebchuk et. al. (n 4) 295-296 on control enhancing mechanisms; Bainbridge (n 5) 6 on the rational apathy of dispersed shareholders.

¹⁶⁸ Berglöf and Burkart (n 71) 197 and 199.

¹⁶⁹ Shleifer and Vishny (n 122) 754.

¹⁷⁰ Shleifer and Vishny (n 122) 759-760.

¹⁷¹ Shleifer and Vishny (n 122) 759-760.

¹⁷² Shleifer and Vishny (n 122) 759-760.

¹⁷³ Shleifer and Vishny (n 122) 767-768 contains a discussion of the risks of other goals than profits prevailing in state run firms.

A special situation of state ownership is those cases where the state holds a so called golden share in a company. A golden share is a term for a share that gives the holder special control rights despite holding very small if any cash-flow rights.¹⁷⁴ This special case combines the potential for conflicting goals inherent in state ownership with the imbalance between control rights and cash-flow inherent in the golden share.

To summarize, the perceived problem with banks and the state as shareholders is the risk that their investment decisions will be taken on different grounds than they would be if they had been ordinary investors. This carries the risk that minority shareholders in the corporations will receive a lower rate of return on their investments and thereby pay for the bank or the state achieving its other goal.¹⁷⁵ Accepting shareholder value as a measure of the efficiency of corporate law, rules accepting that banks and the state lower shareholder value by pursuing other goals that corporate efficiency could be considered potentially inefficient.

4.4 Differential voting rights

A well-known tactic to maintain control of a company without owning the matching cash-flow rights has been implementing differential voting rights.¹⁷⁶ This is done through the corporate charter where certain classes of shares, normally held by the controlling shareholder, have a higher voting power than others.¹⁷⁷ This is still possible in some jurisdictions for example Sweden and the USA.¹⁷⁸ In the Swedish case no share may have a voting power that is more than 10 times as high as any other share even though more extreme differences were allowed earlier.¹⁷⁹ As will be discussed in conjunction with IPO:s the use of differential voting rights to maintain

¹⁷⁴ Grundman and Möslein (n 18) 2-3.

¹⁷⁵ Shleifer and Vishny (n 122) 759-760.

¹⁷⁶ Lin (n 18) 460 and Gilson (n 16) 1646-1647.

¹⁷⁷ Bebchuk et. al. (n 4) 297-298.

¹⁷⁸ Lin (n 18) 461-462.

¹⁷⁹ The 10:1 ratio is found in 4 kap. 5§ Aktiebolagslagen (SFS 2005:551); Bebchuk and Hart (n 27) reported in 2002 that the difference then was 1000 to 1 in Ericsson.

control while introducing a company on the stock exchange is possibly on the rise again, at least in the US.¹⁸⁰

Differentiated voting rights allow a controlling shareholder to retain control rights in excess of the cash-flow rights owned by the shareholder. As discussed earlier this opens for the potential to extract private benefits of control at the expense of the minority shareholders. This in turn opens the possibility of a controlling shareholder turning down a takeover bid that does not adequately compensate for the possibility to extract private benefits of control.

4.5 Pyramids and cross-holdings

As mentioned in the introduction, pyramids and cross-holdings are other common methods for maintaining control rights in excess of the cash-flow rights owned by the shareholder. Compared to differential voting rights they work outside the corporate charter but the end result is the same. The controlling shareholder obtains control rights that are not matched by corresponding cash-flow rights. In the takeover situation, the effects are comparable to other control strategies. The controlling shareholder may choose to decline a value-adding bid since it does not compensate for the loss of private benefits of control.

4.6 Shareholder agreements

As noted earlier shareholders are free to enter into contractual agreements with each other over how to handle their shares.¹⁸¹ The contents of the different contractual agreements which are termed shareholder agreements may be diverse but commonly may include agreements on consultation, how to vote shares and the transferability of the shares.¹⁸² This is in no way uncommon and may just as restrictions on the transferability of shares embodied in the corporate charter serve an entirely legitimate purpose in

¹⁸⁰ Lin (n 18) 462.

¹⁸¹ Ventrizzo (n 2) 425.

¹⁸² Ventrizzo (n 2) 425.

many cases, especially in small or medium sized corporations.¹⁸³ They may however also serve the purpose of maintaining control within a smaller group of owners who together have the potential to control the corporation.¹⁸⁴

The potential problem with shareholder agreements is the risk that the concerned owners will use the corporation to extract private benefits of control, much as any controlling shareholder has the possibility to do. The difference in this case being that control has been achieved in cooperation with others through a shareholder agreement. The main differences compared to the situation with a controlling shareholder is that the extraction requires cooperation between the parties to the shareholder agreement and the degree of transparency in the control mechanism.¹⁸⁵

4.7 Transparency of control

Shareholder agreements as private contracts are not always public knowledge and illustrate another facet of the question of controlling minorities, namely that of transparency.¹⁸⁶ In the case of differential voting rights, the difference between control and cash flow rights is made possible through the corporate charter and potential investors can factor this into their decision. The potential investors do not on the other hand in all jurisdictions have the right to be informed of any potential shareholder agreements.¹⁸⁷ This means that they may come as a total surprise to a shareholder who would not have invested in the corporation given knowledge of the existence of such an agreement.

Two further constructions that may create transparency problems are pyramids and cross holdings which were discussed in more detail in the

¹⁸³ Ventrizzo (n 2) 426-427.

¹⁸⁴ Ventrizzo (n 2) 427.

¹⁸⁵ Ventrizzo (n 2) 425 gives a short overview over the publicity required in different jurisdictions of a shareholder agreement.

¹⁸⁶ Ventrizzo (n 2) 425.

¹⁸⁷ Ventrizzo (n 2) 425.

introduction.¹⁸⁸ This is based on the fact that they involve multiple companies thus increasing the cost of gathering information.¹⁸⁹ The common denominator between them is that they just like the differential voting rights allow a controlling shareholder to retain control over a corporation without owning the corresponding cash-flow rights.¹⁹⁰ This makes them another case of a controlling but non-majority shareholder that may extract private benefits of control at the expense of the other shareholders.

4.8 Initial Public Offers

A resurgence of the use of differential voting rights has been reported in conjunction with the initial listings of some companies in the US.¹⁹¹ This has, for example, allowed the entrepreneurs behind Facebook and Google to retain control of the companies even after the majority of the cash-flow rights has been sold to the public.¹⁹² In the most extreme case shares have been issued that carry no voting rights and without this being compensated for in any other way.¹⁹³

Initial Public Offers of companies, especially companies that have been started by visionaries or in new segments of the economy, are special in that it may well be in the interest of the new owners to entice the old leadership to stay with the company.¹⁹⁴ To achieve this may possibly require giving them enhanced control rights. At the same time, it opens for conflicting interests between the founders whose control rights are not matched by corresponding cash-flow rights and the new majority owners who just as in the case with controlling but non-majority shareholders may risk paying for any private benefits of control that the founders may extract.

¹⁸⁸ Text to n 34 and 37.

¹⁸⁹ Bebchuk et. al. (n 4) note that they require multiple companies.

¹⁹⁰ Lin (n 18)194.

¹⁹¹ Lin (n 18) 462.

¹⁹² Lin (n 18) 484.

¹⁹³ Lin (n 18) 492 discusses the issuance of class C non-voting shares in Facebook.

¹⁹⁴ Lin (n 18) 474 which discusses the possible need for the original entrepreneurs to retain control in order for their vision to be realized.

At the same time that the new investors may wish to retain the services of the founders of the company the founders wish to entice investors in order to cash in on the business they have built. This may give potential investors some leverage against the founders above what is normally available to minority shareholders in companies with a controlling shareholder. Further, it is not uncommon that a financial institution underwrites an IPO, thus guaranteeing its success.¹⁹⁵ This may give the institution in question some degree of leverage over the founders and an interest in making the IPO as attractive as possible for investors.

4.9 Summary

To summarize, the efficiency, or not, of the breakthrough rules will be analysed against the following factors:

- Concentration of ownership, majority owned, controlling shareholder, dispersed
- Banks and states as owners
- Differential voting rights
- Shareholder agreements
- Pyramids and crossholdings
- Initial public offerings (IPO)

¹⁹⁵ Espen B. Eckbo and Ronald W. Masulis and Oyvind Norli, *Security Offerings* in HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE (Vol. 1, B. E. Eckbo, ed., Chapter 6, pp. 233-373, Elsevier/North-Holland Handbook of Finance Series, 2007; Tuck School of Business Working Paper No. 2005-28) 10-11.

5 Interpreting the breakthrough rules

The breakthrough rules of the takeover directive are interpreted using the methodology discussed in section 2.5. In general, a textual analysis is sufficient. However, the requirement that equitable compensation be paid if the rules remove for example differential voting rights is more problematic. It is interpreted in accordance with the goal to create a competitive market economy leading to the conclusion that some compensation is to be paid but not full compensation for all private benefits of control. The interpretation of the breakthrough rules answers the third research question.

5.1 Introduction

The purpose of this chapter is to legally interpret the breakthrough rules of the takeover directive so that they can be analysed against the described theory of economic efficiency. The method for this was described in section 2.5. As a preliminary, case law concerning the takeover directive will be discussed. Thereafter the breakthrough rules will be discussed in terms of restrictions on the transferability of shares, voting rights and compensation.

Case law from the CJEU concerning the takeover directive is comparatively sparse, a search yields a small number of cases.¹⁹⁶ However, none of the cases concern the application of the breakthrough rules of article 11. Based on this absence of case law it is concluded that the breakthrough rules of the directive must be interpreted primarily based on their textual meaning and if this is not sufficient using a teleological method.

This implies that when interpreting the breakthrough rules we must in those cases where the text is not sufficiently clear let us be guided by the

¹⁹⁶ For example, the pending case 658/16 Elliot International and Others concerning the proper application of article 5(4) of the takeover directive and the judgement in case C-101/08 Audiolux SA e.a v Groupe Bruxelles Lambert SA (GBL) and Others and Bertelsmann AG and Others (2009) ECR I-09823 concerning article 3(1) of the takeover directive.

overarching goals stated in the treaties and the specific goals attendant to the takeover directive.¹⁹⁷ Since the directive concerns the functioning of the capital market the freedom of movement of capital is noted in the preamble to the directive itself.¹⁹⁸ Any interpretation of the directive must therefore be in conformity with the interpretation of the CJEU of the requirements of the freedom of movement of capital as expressed in the treaties.

With these guides to interpretation in hand attention now turns to the text of article 11 of the directive. The discussion is divided into separate sections on voting rights, the transferability of shares and compensation.

5.2 Voting rights

Paragraphs 3 and 4 of article 11 have an impact on voting rights and will be examined in this section. Since paragraph 4 refers back to paragraph 3 it will be examined in detail first. The exact wording is as follows:

“Restrictions on voting rights provided for in the articles of association of the offeree company shall not have effect at the general meeting of shareholders which decides on any defensive measures in accordance with article 9.

Restrictions on voting rights provided for in contractual agreements between the offeree company and holders of its securities or in contractual agreements between holders of the offeree company’s securities entered into after the adoption of this directive shall not have effect at the general meeting of shareholders which decides on any defensive measures in accordance with article 9.

Multiple-vote securities shall only carry one vote each at the general meeting of shareholders which decides on any defensive measures in accordance with article 9.”¹⁹⁹

At first glance this article is unambiguous. At a general meeting called to discuss defensive measures in reaction to a bid on the shares of the company each share will have one vote and any restrictions on one voting are null and void no matter if they are enshrined in the company charter or a shareholder

¹⁹⁷ Text to n 107.

¹⁹⁸ Takeover directive, Recital (20) of the preamble.

¹⁹⁹ Takeover directive art 11 paragraph 3.

agreement. The sole exception to this rule concerns shares whose restriction on voting rights is financially compensated in some way, for example preferred stock.²⁰⁰

The question is however complicated by the reference to article 9 and the fact that implementing article 9(2) and 9(3) is optional for member states.²⁰¹ It is also worth noting that a member state can choose to opt out of article 9 and 11 independently of each other, it is not necessary to make the same choice in regard to both articles.²⁰²

If a member state has chosen to implement article 11 and article 9 in its entirety the rule is as noted unambiguous. At a general meeting called to discuss defensive measures in regard to a bid, restrictions on voting rights are nullified. The clear language means that further interpretation is not necessary.

If, however, a member state chose to implement article 11 but not article 9 we must discuss if the part of article 11 which impacts on voting rights has any effect at all or not. The text explicitly states that the voting rights are abrogated only in a situation in accordance with article 9. A textual interpretation leads to the conclusion that it is only if article 9 has been adopted that the breakthrough rules can be applied to voting rights. In other cases, they have no effect.

The exception to this rule arises in conjunction with article 9(4). While the preceding discussion concerned how the breakthrough rules may modify voting rights before a takeover or share purchase has taken place, this paragraph concerns itself with voting rights at a general meeting after the new owner has purchased at least 75 percent of the capital of the company if the meeting has been called to amend the corporate charter or elect board members.²⁰³ The paragraph states that in this situation voting rights are

²⁰⁰ Takeover directive art 11 paragraph 6.

²⁰¹ Takeover directive art 12

²⁰² Takeover directive art 12 paragraph 1. This follows from the use of the phrase and/or at the end of the paragraph.

²⁰³ Takeover directive art 9 paragraph 4.

modified in the same way as in paragraph 3. In addition, any special rights given to specific shareholders regarding the appointment of board members are abrogated.²⁰⁴

Article 11(4) does refer to the earlier paragraphs for a definition of what rights are nullified. This cannot be construed as to include the reference to article 9. Therefore, it is operative irrespective of whether or not article 9 has been implemented or not.²⁰⁵ The effect of a breakthrough in accordance with this paragraph is therefore to allow a new supermajority owner to amend the corporate charter even if it contains provisions which would protect a controlling but minority shareholder. Further it hinders the old controlling shareholder from blocking the election of a new board through any mechanisms affected by the breakthrough rules.²⁰⁶

5.3 Transferability of shares

Article 11(2) of the takeover directive concerns restrictions on the transferability of shares and has the following wording:

“Any restrictions on the transfer of securities provided for in the articles of association of the offeree company shall not apply vis-à-vis the offeror during the time allowed for acceptance of the bid laid down in article 7(1).

Any restrictions on the transfer of securities provided for in contractual agreements between the offeree company and holders of its securities, or in contractual agreements between holders of the offeree company’s securities entered into after the adoption of this Directive, shall not apply vis-à-vis the offeror during the time allowed for acceptance of the bid laid down in article 7(1).”²⁰⁷

In this case the wording is unambiguous, it is clear that restrictions on the transferability of shares are set aside during the period of a bid offer

²⁰⁴ Takeover directive art 11 paragraph 4.

²⁰⁵ Takeover directive art 11 paragraph 4 includes the text” voting rights referred to in paragraphs 2 and 3” which defines the voting rights. Paragraphs 2 and 3 refer to article 9 to determine when these rights are nullified. When the breakthrough desired by article 11(4) is to take place is defined in the paragraph itself so the reference to article 9 is not relevant for article 11(4).

²⁰⁶ Takeover directive art 11 paragraph 4.

²⁰⁷ Takeover directive art 11 paragraph 2.

irrespective of whether the restriction is part of the corporate charter or a contractual agreement. The restrictions on transferability are however only set aside regarding the bidder. They remain in effect in respect to all other potential buyers of shares in the company.²⁰⁸

5.4 Compensation

Article 11(5) of the breakthrough directive concerns losses incurred by the implementation of the breakthrough rules and mandates that compensation shall be paid. The paragraph has the following wording:

“Where rights are removed on the basis of paragraphs 2, 3, or 4 and/or Article 12, equitable compensation shall be provided for any loss suffered by the holders of those rights. The terms for determining such compensation and the arrangements for its payment shall be set by the Member States.”²⁰⁹

From this article, it is clear that a member state that chooses to implement the breakthrough rules has a duty to ensure that shareholders whose rights are removed under the provisions regarding voting rights and the transferability of shares are to be compensated. Since the directive is silent on the matter it is less clear how it is to be calculated.

The question of compensation is important since it has effects for the cost to the bidder of acquiring control over the company.²¹⁰ This cost cannot be calculated without a clear understanding of the requirement for compensation of the takeover directive. Before delving deeper into the exact requirements, it is worthwhile to discuss what could theoretically be compensated for.

A controlling shareholder whose control rights exceed the cash-flow rights has, as has been discussed earlier, the possibility to extract private benefits of control.²¹¹ In the case of different share classes with differential voting

²⁰⁸ Takeover directive art 11 paragraph 2.

²⁰⁹ Takeover directive art 11 paragraph 5.

²¹⁰ Text to n 157

²¹¹ Gilson (n 16) 1651.

rights this difference in control rights is impounded in the share price and the shares with greater control rights are publicly traded at a higher price under the label control premium.²¹² A full compensation of losses incurred by the controlling shareholder would therefore have to compensate for this loss of control rights.

This seems to have been the position taken by Italy when it initially chose to implement the breakthrough rules based on the fact that courts could base their decision on compensation on share prices.²¹³ The Swedish government on the other hand when discussing the possibility that companies would choose to implement the breakthrough rules through the corporate charter held that compensation would rarely become an issue.²¹⁴

While the rules for calculating the compensation to be paid for losses incurred under the breakthrough rules are left to the member states to formulate, the CJEU will be the final arbiter of if these rules fulfil the requirement of equitable compensation. At this point it is worth noting that the directive text does not require full compensation merely that it has to be equitable. This allows the court some leeway to interpret the directive such as to fulfil other overarching goals of the EU.

The objectives of the directive are transparency and ensuring that cross-border mergers are not unduly hindered.²¹⁵ Outside of the directive one aim of the EU is the creation of ‘a highly competitive social market economy’.²¹⁶ Another is the goal of creating an ever-closer union which has been cited since the founding of the EEC.²¹⁷

²¹² Aswath Damodaran, *The Value of Control: Implications for Control Premia, Minority Discounts and Voting Share Differentials* (June 30, 2005) 50-51.

²¹³ Cleary Gottlieb (n 65) 4.

²¹⁴ Proposition 2005/06: 140 *Offentliga Uppköpserbjudanden på aktiemarknaden* (2006) 68.

²¹⁵ Takeover directive, recital 3 of the preamble.

²¹⁶ Treaty on the European Union art 3 paragraph 3.

²¹⁷ Neergard and Nielsen (n 106) 114 and with reference to article 2 of the treaty establishing the EEC.

The goal of creating a highly competitive market economy resonates with the role of corporate law to promote economic efficiency. As has been discussed this implies making it possible for value-adding takeover bids to succeed.²¹⁸ It has also been discussed how stringent requirements that all losses of private benefits of control have to be compensated for may stop otherwise value-adding takeovers from taking place.²¹⁹

A teleological interpretation of the requirement for equitable compensation is therefore not compatible with a requirement that all losses of private benefits of control are to be compensated for since such an interpretation would in all likelihood block many value-adding takeover bids. It would also in practice set aside the equal price rule of article 5 of the takeover directive. This conclusion is based on the fact that the payment of full compensation for the loss of private benefits of control in addition to the price paid for the shares would in practice open up for the possibility that controlling shareholders will be paid a higher price for their shares than other shareholders.

Regarding the fundamental goal of an ever-closer union this together with the freedom of capital within the union can be taken to preclude any nationality-based restrictions with regard to takeovers.²²⁰ The compensation rules of article 11(5) are on the other hand not affected by the nationality of either the bidder or incumbent owner making this goal of lesser interest for this interpretation.

The conclusion taken from this discussion is that courts applying national law in the case of a dispute over compensation must award compensation for the loss of private benefits of control. They must on the other hand not award such high compensations as to hinder value-adding takeovers. This would seem to be a position somewhere between the two extremes represented by Italy and Sweden, some compensation, but possibly not full

²¹⁸ Berglöf and Burkart (n 71) 196-199.

²¹⁹ Text to n 157.

²²⁰ Treaty on the Functioning of the European Union art 63 guarantees the freedom of movement regarding capital.

compensation for the loss of the control premium, while on the other hand not more or less ruling out any possibility of compensation as in the Swedish case.

5.5 Exemptions

Paragraphs 6 and 7 of article 11 contain provisions that exempt certain shares from the effects of the breakthrough rules. Paragraph 6 exempts shares whose limited voting rights is already compensated for monetarily.²²¹ The other case is the so called “golden shares” to which paragraph 7 refers.²²² In these cases the state, often in conjunction with a privatization, has retained a right to veto certain decisions through the ownership of shares with certain special rights.²²³ The text is clear in its meaning and only state-owned shares can be exempted through it.

Finally, not all shareholder agreements are set aside by the breakthrough rules. Concerning both voting rights and the transferability of shares only such agreements that have been entered into after the adoption of the directive are set aside.²²⁴ On one hand the wording is at first glance clear; the cut-off date is the adoption date of the takeover directive. On the other hand, such an interpretation may give the result that if a member state adopts the breakthrough rules in say 20 years’ time shareholder agreements that go back maybe decades in time are so to speak retroactively affected.

In those cases where a company adopts the rules through its charter such an effect can be possibly defended since the possibility to do so has existed during the whole period from the adoption of the national rules implementing the directive. In the case of a change in national law there is a conflict between a clear textual meaning, the adoption date of the directive is the cut-off date and the perceived purpose of the rule. Evidently the rule

²²¹ Takeover directive, art 11 paragraph 5.

²²² Grundmann and Möslein (n 18) contains a general discussion on golden shares.

²²³ Grundmann and Möslein (n 18) 2-4.

²²⁴ Takeover directive, art 11 paragraph 2 subparagraph 2 and article 11 paragraph 3 subparagraph 2.

strives to not affect agreements entered into before the directive became binding.

Given the pre-eminence of the teleological method in the interpretation of EU law it is difficult to simply brush aside the conflict citing a clear wording. For this reason, the rule is interpreted to mean that should a member state at a date after that at which the directive is implemented choose to adopt the breakthrough rule that date is the cut-off date for the validity of shareholder agreements affecting the voting rights or transferability of shares.

5.6 Summary regarding interpretation

We summarize the above interpretation of the breakthrough rules by noting a number of key points:

- Restrictions on voting rights and differential voting rights during the bid phase are broken through only if the member state has also adopted article 9.
- Restrictions on the transferability of stock are always broken through.
- A successful bidder who has acquired at 75% percent of the capital can take control over the corporation at a general meeting after the takeover relying on the breakthrough rules to nullify restrictions on voting rights and transferability. Differential voting rights do not apply at such a meeting.
- A successful bidder must pay compensation to the holder of the rights that are nullified by the breakthrough rules. The size of the compensation may not unduly threaten value-adding takeovers.
- The voting limitations of preferred stock and special rights of golden shares are not affected.
- Shareholder agreements entered into before the breakthrough rules are adopted by a member state are not affected as regards limitations in the voting rights or transferability of shares.

6 Analysis

The breakthrough rules are tested against the different methods available to controlling shareholders with which to retain control using the three-step test devised in chapter three. It is found that in most cases the breakthrough rules either will not affect the situation or that they can be circumvented by a determined controlling shareholder and that there is in most cases little advantage to be found in implementing the breakthrough rules. Initial public offers are analysed separately and it is found there may be some advantage to introducing the rules in the corporate charter in order to build confidence with investors. This is dependent on the founders being able to convince investors that they will not attempt to evade the breakthrough rules.

6.1 Introduction

The previous chapters have set up the framework through which the breakthrough rules are to be evaluated, discussed the different aspects of controlling shareholders against which the breakthrough rules are to be tested and interpreted the rules themselves. This chapter moves on to analysing the rules against this background

First the analysis is carried out regarding a number of different mechanisms for a controlling shareholder to retain control rights in excess of the cash-flow rights. A special section is devoted to the case of initial public offers. Thereafter the rule that gives a successful bidder who has acquired at least 75 percent of the cash-flow rights is analysed.

The analysis is carried out by applying the three-step test developed in chapter three to the specifics of each situation. Conclusions are drawn in each case. These conclusions are then carried forward into the final chapter of the thesis where the effects of the requirement for compensation to be paid to a controlling shareholder whose rights are removed by the application of the breakthrough rules is taken into account.

If nothing else is noted specifically the analysis draws upon the material presented in chapters three through five. In those cases where new material is introduced or if a particular author is referenced this will be referenced separately.

6.2 Short recapitulation of the tests

Before commencing the actual analysis, a short recapitulation of the tests that are to be carried out is made. They are:

- The test of necessity. Are controlling shareholders with greater control rights than cash-flow rights present? Are there signs of bad law or the extraction of large private benefits of control?
- The test of theoretical suitability. Is there a large degree of separation between control rights and cash-flow rights? Is there a potential to extract large private benefits of control? Are the enhanced control rights affected by the breakthrough rules?
- The test of practical suitability. Is it difficult or costly to evade the rules? Is it manageable to pay the required compensation?

Only if the answer to all these questions is yes can it be considered advantageous to implement the breakthrough rules. While there is a certain order to these tests it will not be followed in every instance. Should it be evident that the breakthrough rules will fail a later test in some instance the earlier tests will not be carried out.

6.3 Controlling shareholders

6.3.1 Common themes

Should a company have a majority shareholder, and in the absence of any golden shares or other mechanism giving someone else enhanced control rights, the majority shareholder is free to turn down any takeover bids. In this case control rights and cash-flow rights are substantially aligned. The first test, the test of necessity has as its first element to look for differences

between control rights and cash-flow rights. Since these are not present in this case the situation fails the test of necessity and it is not advantageous to implement the breakthrough rules in this case.

In the case of a company with dispersed ownership the control rights and cash-flow-rights are also already aligned. This case therefore also fails the test of necessity. Having summarily removed these two situations from consideration attention is now turned to the case of a company with a controlling but non-majority shareholder.

In this case control rights and cash-flow rights are not aligned, leading to a situation where the controlling shareholder may wish to extract private benefits of control at the expense of the minority shareholders. The first test, that of necessity begins by looking for a situation where control rights and cash-flow rights are not aligned. As this is the case the case of a controlling shareholder passes the test in this regard.

Moving on, the test of necessity examines if bad law or the extraction of large private benefits of control is present. This will be dependent on the individual situation. The question of the quality of the applicable law will be the same throughout a jurisdiction but the size of the private benefits of control may vary between owners implying that when analysing whether or not an individual company should implement the breakthrough rules in the corporate charter the conclusion may be dependent on the particular controlling shareholder.

To conclude this discussion; The case of a controlling but non-majority shareholder passes the test of necessity especially if there is a case of bad law or if the shareholders, either generally in the case of a jurisdiction or in the individual case if the analysis is performed on the level of an individual company, are likely to extract large private benefits of control. Having noted this, we move on to the two later tests. In order to structure the discussion, the analysis is conducted separately depending on the method used to achieve the separation of control rights and cash-flow rights.

6.3.2 Differentiated voting rights

First, we study the case where a controlling shareholder has used differentiated voting rights to separate control rights from cash-flow rights. It has already been noted that this situation passes the test of necessity. It is now time to apply the test of theoretical suitability which looks at the degree of separation between control rights and cash-flow rights, the size of private benefits of control and if the breakthrough rules are able to realign control rights and cash-flow rights.

In the case of differentiated voting rights, we find that the greater the difference between control rights and cash-flow rights the greater likelihood that the breakthrough rules will be advantageous. The same also holds regarding the size of private benefits of control. The larger they are the greater the likelihood that it will be advantageous to implement the breakthrough rules. Finally, we find that the breakthrough rules are capable of aligning the control rights with the cash-flow rights since they replace the differentiated voting rights with the principle of one-share one-vote during the takeover process. A proposal to implement the breakthrough rules therefore passes the test of theoretical suitability in the case of differentiated voting rights and it is possible to move on to the third test.

The test of practical suitability looks at the possibility of evading the effects of the breakthrough rules. As Bebchuk and Hart noted a controlling shareholder can plan ahead before any takeover bids are made and choose to move the basis of control from differential voting rights to, for example a pyramid scheme which is unaffected by the breakthrough rules.²²⁵ Thus, in most cases implementing the breakthrough rules fail the third test in regard to differential voting rights since there are methods for a determined controlling shareholder to circumvent the rules.

The exception to this would be if the controlling shareholder is unable or unwilling to switch to another method of separating control rights from

²²⁵ Bebchuk and Hart (n 27) 1-2.

cash-flow rights. Considering the fact that a proposal to implement the breakthrough rules in many cases fails the test of practical suitability it is not immediately advantageous to implement them to counter the effects of differentiated voting rights, especially as there may be beneficial effects from the existence of controlling shareholders in disciplining management.

6.3.3 Shareholder agreements

A second control method explicitly targeted by the breakthrough rules is the use of shareholder agreements. They do so by simply stating that restrictions on transferability and voting rights embodied in such agreements do not apply in the takeover situation.²²⁶ This has the effect that a party to such an agreement cannot be forced to abide by it. However, there is no prohibition on the parties to voluntarily continue following the agreement for reasons of their own.

Once again applying the test of theoretical suitability to the situation where controlling shareholders have used shareholder agreements to separate control rights and cash-flow rights the findings parallel those where differentiated voting rights have been used. Provided that one or more of the parties to the agreement is willing to break the agreement, the breakthrough rules can realign control rights and cash-flow rights and the benefits are likely larger the larger the separation is between control and cash-flow rights as well as in cases of large private benefits of control being extracted. The situation of control being exerted through shareholder agreements therefore passes the test of theoretical suitability and it is possible to move on to the third test.

Moving on to the third test, that of practical suitability or the possibility of evasion, we find that a controlling shareholder who is dependent on a shareholder agreement has two options in order to retain control. Either to switch to another control mechanism or to convince the other parties to the

²²⁶ Takeover directive, art 11 paragraph 2 subparagraph 2 and article 11 paragraph 3 subparagraph 2.

shareholder agreement to continue to honour it even though they cannot be forced to do so. The first would be a form of evasion and would mean that a proposal to implement the breakthrough rules fails the third test. It would however require the capital to invest in further shares and so is not an obvious failure especially since existing owners cannot be compelled to sell the necessary shares.

There is a risk that parties to a shareholder agreement may continue to abide by it based on the same reasons that induced them to enter into it in the first instance. They could for example wish to retain the ability to extract private benefits of control. If this is the case it would also mean that this situation has failed the third test, that of practical suitability.

To summarize, the situation where control is exercised through a shareholder agreement passes the test of necessity and the test of theoretical suitability. In the case of the test of practical suitability it is however less clear-cut. In some instances, the situation may pass the test, in others not. It is therefore not immediately clear if it would be advantageous to implement the breakthrough rules or not to counter the effects of shareholder agreements. It is also worth noting that the breakthrough rules have no effect on older shareholder agreements.

6.3.4 Pyramids and cross-holdings

The functioning of pyramids and cross holdings is not affected by the breakthrough rules.²²⁷ A situation where a controlling shareholder relies on either of these techniques therefore fails the test of theoretical suitability since the breakthrough rules are not capable of realigning the control rights with the cash-flow rights. If controlling shareholders commonly base their control on either pyramids or crossholdings it is not advantageous to implement the breakthrough rules since it was assumed that in cases where the proposed regulation is ineffectual it is better to not regulate.

²²⁷ Bebchuk and Hart (n 27) 1-2.

6.3.5 States and golden shares

One special case of a minority shareholder being able to block an otherwise value-adding takeover bid is when a state exerts control through possessing a golden share. As discussed earlier this means that the state is given a deciding control right in one or several situations with little or maybe no corresponding cash-flow rights.

This situation is clearly a case of control rights being separated from cash-flow rights. However, because of the exemption from the breakthrough rules of golden shares it fails the second test, that of theoretical suitability since the breakthrough rules are unable to realign the control rights with the cash-flow rights. As is the case with pyramids and cross-holdings and based on the same assumption it is not therefore advantageous to implement the breakthrough rules in this case either.

6.4 Banks

It was noted earlier that banks may have interests and preferences that diverge from other shareholders. In those cases where a bank holds control rights in excess of their cash-flow rights this could lead to the bank following its own preferences, the ability to do so can be compared to a private benefit of control which the bank would be extracting at the expense of other shareholders. In such a case, the analysis can proceed as is the case with other controlling shareholders.

The exact details of the analysis will depend on which method the bank in question has used to separate the control rights from the cash-flow rights, the quality of law and the size of the private benefits of control being extracted in the form of prioritizing the banks agenda ahead of shareholder value. Finally, the value of the bank as in the form of exerting control over management and thereby curbing the benefits of control that it can extract must be taken into account. This is done in the same way as for other controlling shareholders.

6.5 Initial public offerings (IPO)

IPO:s where a founding owner retains control rights in excess of the cash-flow rights will in general be analysed as any other such situation with reference to the above discussion. However, two elements are added to the analysis. The investors may have an increased degree of leverage over the founders as discussed earlier and the founders who wish to cash in on their earlier work need to entice the investors to invest in the IPO.²²⁸

Applying the test of necessity, we find that in cases where control rights and cash-flow rights are not aligned the situation passes the first test especially if bad law or large private benefits of control are present. The analysis in this part does not differ from the non-IPO situation. Moving on to the second test, that of theoretical suitability, we find that the breakthrough rules will align the control rights with the cash-flow rights if the founders have chosen differential voting rights as the mechanism for retaining control. In case of a shareholder agreement the situation is more unclear since the founders cannot be forced to break the agreement. We therefore find that in cases of differential voting rights this situation passes the second test, that of theoretical suitability.

Moving on to the third test, that of practical suitability we find the same possibility as earlier that the controlling shareholder may try to evade the breakthrough rules by changing the mechanism by which control is retained.²²⁹ However, should the controlling shareholder be able to convince the minority owners that this will not happen, at least not for the foreseeable future the IPO situation will pass the third test, that of practical suitability.

This is based on the special situation of the IPO where the founders as controlling shareholders need the investors in a different way than is the case in the mid-stream phase of a company's existence, giving the investors an increased degree of leverage over the controlling shareholder. This

²²⁸ Text at n 195.

²²⁹ As for differentiated voting rights.

increased leverage may mean that the controlling shareholder is more willing to provide assurance that the control mechanism will not be changed. Frankly, the investors are able to demand assurances in return for capital.

6.6 The 75% Rule

Lastly, the analysis will touch upon a part of the breakthrough rules that applies to the post-takeover situation. This rule is meant to ensure that a controlling shareholder is not able to continue to exert this control after a successful takeover bid and is considered separately from the earlier discussion which has taken its start in characteristics of the ownership of the company.

The rule mandates that a bidder who has acquired at least 75 percent of the cash flow rights is able to shortly after the takeover call a general meeting during which differential voting rights and restrictions on voting rights and the transfer of shares are set aside.²³⁰ Any provisions in the charter giving any shareholder special rights regarding the composition of the board are also set aside.²³¹ The effect is to align control rights with cash-flow rights in those areas that are affected by the rule.

When applying the first test, that of necessity to this rule we find that the situation that a minority shareholder exercises special rights at a general meeting is a clear case of a separation of control rights from cash-flow rights. This conclusion is based on the fact that this rule only applies if the successful bidder has acquired at least 75 percent of the cash-flow rights.

Restrictions in the corporate charter of this nature may preclude a new owner of the majority of the cash-flow rights from exercising control of the company. As such the situation passes the first test, that of necessity, especially if there is bad law or large private benefits of control.

²³⁰ Takeover directive, art 11 paragraph 4.

²³¹ Takeover directive, art 11 paragraph 4.

Regarding the second test, that of theoretical suitability we note that the provisions of the breakthrough directive are capable of realigning the control rights and cash-flow rights in this case based on the fact that the restrictions are embodied in the corporate charter which is susceptible to legal intervention. This situation therefore passes the second test.

In regard to the third test, that of practical suitability which begins by testing if the proposed rule can be evaded it has however been pointed out that an incumbent controlling shareholder can counter the effects of the 75 percent rule provided the financial means are available to increase its ownership to more than 25 percent.²³² This would deprive any potential new majority owner of the possibility of relying on the breakthrough rule in this aspect.²³³

Under the assumption that the incumbent owners have the financial ability to increase their holdings even slightly above the 25 percent threshold they therefore have the ability to pre-emptively block a potential successful takeover bidder from removing defensive measures from the corporate charter after the takeover. This would make a potentially value-adding takeover less interesting to the bidder since the ability to add value through the takeover may be dependent on acquiring control over the company. The rule thereby fails the third test since it is in many situations possible for a controlling shareholder to evade its effects and it is not advantageous to implement the breakthrough rules with regard to this rule.

²³² Bebchuk and Hart (n 27) 1-2.

²³³ Takeover directive, art 11 paragraph 4 requires the new majority owner to own at least 75 percent of the cash-flow rights for the rule to be applicable.

7 Conclusions

Conclusions are drawn from the analysis in the previous chapter and the effects of the requirement to pay compensation to controlling shareholders is assessed. It is found that there are few situations when it is advantageous to implement the breakthrough rules. The most promising situation is that of initial public offers. All situations are highly dependent on the level of compensation that is required and the clarity of the rules regarding this.

7.1 Introduction

The previous chapter analysed the potential effects of introducing the breakthrough rules against a number of different methods by which controlling shareholders may seek to separate control rights and cash-flow rights. This section fulfils the purpose of the thesis by using this analysis to make a normative judgement on the breakthrough rules. More precisely it will discuss if and under what circumstances it is advantageous for a member state or an individual company to choose to implement the rules. The two cases are discussed separately.

7.2 Should member states implement

When studying companies in the mid-stream phase of their existence little evidence is found that it is advantageous to implement the breakthrough rules for a member state. Berglöf and Burkart note that in theory the rules combined with the demand that all shareholders are offered the same price would ensure that all value-adding takeovers and only those take place.²³⁴ However, the rules only affect some methods for separating control rights and cash-flow rights. Pyramids, cross-holdings and the golden shares of states are found to be unaffected.

Should a state choose to implement the breakthrough rules, value-adding takeovers aimed at companies whose controlling shareholders utilize

²³⁴ Berglöf and Burkart (n 71) 197 and 199.

differentiated voting rights or shareholder agreements will have a higher probability to succeed since the breakthrough rules were found to align control rights with cash-flow rights in these cases. However, as advantageous as this might seem it brings with it the risk that determined controlling shareholders will transfer from primarily differentiated voting rights to other control mechanisms such as pyramids and cross-holdings that are not affected by the breakthrough rules.²³⁵

It is also worth remembering Gilson's thoughts on good versus bad law and the size of private benefits of control.²³⁶ He states that the presence of controlling shareholders may actually benefit the minority shareholders provided that the laws are of good quality and that the extracted private benefits of control are less than the amount gained from disciplining management.²³⁷ This actually reduces the already indistinct advantages of implementing the breakthrough rules in those cases where good law or small private benefits of control are present. In these cases, it may be more advantageous to accept the down-sides of the existence of controlling shareholders than to implement the breakthrough rules and risk losing the disciplining effect on management provided by the controlling shareholders.

The question is further complicated by the compensation rule of the breakthrough rules. The uncertainty of how to calculate the necessary compensation risks means that it may be difficult or even impossible for a bidder to calculate the true cost of a takeover bid. This may lead to a situation where in theory the breakthrough rules would be advantageous but in practice there is an opposite reaction where potential bidders become wary of exposing themselves to claims for compensation that are difficult to calculate. This problem can be alleviated, at least to some extent, if member states create clear rules regarding how compensation is to be calculated.²³⁸

²³⁵ Bebchuk and Hart (n 27) 1-2.

²³⁶ Text at n 139.

²³⁷ Lin (n 18) 472 also notes that there is a value in the disciplining of management provided by controlling shareholders that may well exceed the cost to the minority shareholders of there being a controlling shareholder.

²³⁸ Takeover directive, art 11 paragraph 5 charges the member states with creating detailed rules regarding how compensation is to be calculated.

To summarize; under the following circumstances it would be advantageous for a member state to implement the breakthrough rules:

- The main control strategy used by controlling shareholders is differentiated voting rights.
- Controlling shareholders are unlikely to choose another strategy.
- The jurisdiction is characterized by bad law and/or high private benefits of control.
- The required compensation has been clearly defined.

In addition, the breakthrough rules may have some advantageous effects on shareholder agreements under the same conditions regarding law and the size of private benefits of control. Since a consensus was found regarding the likelihood that controlling shareholders would choose to move to some other control mechanism, for example pyramid structures, when prior research was summarized the combination of circumstances required for the breakthrough rules to be advantageous seems less likely to occur in reality.

7.3 Should companies implement

7.3.1 The mid-stream phase

So far, the discussion has concerned the mid-stream phase of companies and when it is advantageous for member state to implement the rules on a national level. The attention now turns to under what circumstances it would be advantageous for a company to implement the rules through the corporate charter.

For companies in the mid-stream phase the conclusions parallel that regarding when it is advantageous for a state to implement the rules. The basic premises are the same even if the decision can be more closely tailored to the specific situation of the individual company. On the other hand, there could be a down-side to one company introducing rules through the corporate charter that differ widely from those that are prevailing within the

jurisdiction since bespoke corporate charter arrangements may introduce an element of legal uncertainty.²³⁹

On balance the conclusion is that for firms in the mid-stream phase of their existence special circumstances must be present for it to be advantageous to implement the breakthrough rules through the corporate charter. In those cases where it would be undeniably advantageous, and these are those cases where control is leveraged through differentiated voting rights or possibly shareholder agreements it is also questionable if the controlling shareholder has any incentive to risk the controlling position that it enjoys.

7.3.2 The IPO-phase

When discussing a company on the brink of going public the conclusions become slightly different. The main conclusions regarding which circumstances are required for it to be advantageous to adopt the breakthrough rules are the same. We must be considering using differential voting shares or possibly a shareholder agreement to retain control, there must be a potential for the extraction of large private benefits of control and the compensation rules must be clear. If this is the case the situation fulfils the three-step test applied in the analysis.

Added to this is the special situation inherent in the IPO. The founders may want to instil a greater confidence in investors who might have greater leverage on the company going public than is normally the case. This could create the opening for the founders to adopt the breakthrough rules through the corporate charter in order to attract more investors. The likelihood of this is reduced by the use of standardized corporate charters in IPO situations.²⁴⁰ Leaving this norm may entail an offsetting confidence loss based on the risk of bespoke solutions creating legal ambiguity making it less advantageous to adopt the breakthrough rules.

²³⁹ Lin (n 18) 483 discusses this in conjunction with IPO:s.

²⁴⁰ Lin (n 18) 483.

At this point the IPO-phase seems the most promising from the point of view of finding situations when it would be advantageous to implement the breakthrough rules through the corporate charter. This is however dependant on three key factors. These are:

- The founders must be attempting to retain control through differentiated voting rights and be able to project that they will continue to do so.
- The rules regarding compensation must be clear and not prohibitively expensive.
- It must be possible to contain the legal ambiguities inherent in bespoke solutions.

Only if all these three factors are present will it in practice be advantageous to implement the breakthrough rules through the corporate charter.

7.4 Final verdict

To summarize, little evidence has been found indicating that it is advantageous for member states to implement the breakthrough rules of the takeover directive. In those situations where the rules are theoretically suitable, differential voting rights, bad law and high private benefits of control, the risk of evasion through pyramids or cross-ownership is likely to cancel out the benefits of implementing them.

The same reasoning generally applies when a company is evaluating the possibility of implementing the rules through the corporate charter. However, since the rules would only apply to one company it is possible that those circumstances that make an implementation advantageous would apply to this one company even if it would not be advantageous for the state to adopt the rules as mandatory for all companies. This could increase the likelihood of an advantageous situation being present with regard to one company somewhat compared to when the analysis was performed on the member state level.

However, the legal uncertainties inherent in bespoke solutions and the requirement to pay compensation and the uncertainty of how this compensation is to be calculated make it less likely that it will be advantageous to implement the breakthrough rules through the corporate charter. This decreases the number of situations when it will be advantageous. Taken together the conclusion is that while there may be special cases where it is advantageous for a company to adopt the breakthrough rules through the corporate charter even though it is not advantageous for the member state these situations will be an exception.

Turning to the IPO situation it was found that since investors, especially those underwriting the IPO, are likely to have increased leverage over founders contemplating an IPO this situation is the more likely to show advantages to implementing the breakthrough rules through the corporate charter. Having said this it is worth remembering that the corporate charter is seldom customized in the case of an IPO.²⁴¹

It is instead reported that most IPO:s use standardized charters irrespective of if they are a good fit for the specific company or not.²⁴² The question then becomes if the gain in investor confidence accruing from the use of the breakthrough rules offsets the loss to be expected from the potential legal ambiguity inherent in the use of non-standard provisions. As before, the analysis is very dependent on the rules regarding compensation.

To summarize; there are few situations when it is advantageous to implement the breakthrough rules, primarily since they cover far from all methods of separating control rights and cash-flow rights and in many instances, can be evaded. This holds true in most instances for the individual company case as well as on the national level. The most promising situation is that concerning IPO:s. If it in the end will be advantageous or not is highly dependent on the size of the compensation which must possibly later be paid to controlling shareholders under the breakthrough rules.

²⁴¹ Lin (n 18) 485.

²⁴² Lin (n 18) 485.

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