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# European Takeover Law and the Freedom of Establishment: Towards Efficient Regulation

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## **Abstract**

The European Takeover Bids Directive has been at the centre of criticism since it was adopted on 21 April 2004. This study adds a voice to the enduring discourse on the extent to which the Directive is fit for purpose. Specifically, the study considers whether and, if so, how the Directive could be reformed in order to facilitate the exercise of the freedom of establishment of companies through takeovers in a more efficient manner. The study culminates in three main reform proposals. First, it calls for the enhancement of pre-bid disclosure requirements as a way of addressing pre-bid takeover defences, in place of the breakthrough rule which has barely been transposed by EU Member States. Second, the study proposes that the task of drawing up an opinion on the merits of a public takeover bid for the benefit of stakeholders should be entrusted to independent experts instead of the board of the target company, to ameliorate agency problems. Third, the study recommends that the mandatory bid rule should be ‘transformed’ into a sell-out right, to render it more effective in protecting minority shareholders whilst mitigating its chilling effect on the market for corporate control.

## **Table of Abbreviations**

BNR	Board Neutrality Rule
BTR	Breakthrough Rule
CEM	Control Enhancing Mechanism
CJEU	Court of Justice of the European Union
EU	European Union
MBR	Mandatory Bid Rule
SEC	Securities and Exchange Commission
SMEs	Small and Medium-Sized Enterprises
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom
US	United States of America

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# 1 Introduction and Background

## 1.1 Introduction

The freedom of establishment of companies is a central element of the internal market of the European Union (EU). It ‘is especially important in relation to public limited liability companies because their activities predominate in the economy of the Member States and frequently extend beyond their national boundaries.’<sup>1</sup> Small and medium-sized enterprises (SMEs) too have been recognised as essential players in strengthening the EU economy, especially in the face of an economic crisis.<sup>2</sup> In this vein, the European Commission has tabled a proposal for a new directive on single-member private limited liability companies to facilitate the establishment of cross-border subsidiaries by SMEs within the EU.<sup>3</sup>

Generally speaking, the right of establishment enshrined in Article 49 of the Treaty on the Functioning of the European Union (TFEU),<sup>4</sup> read in conjunction with Article 54 TFEU, protects all forms of business organisations and individuals alike.<sup>5</sup> It entitles nationals of Member States and firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the EU to set up and manage businesses across borders under the conditions laid down by the legislation of the Member State where the establishment is effected.<sup>6</sup> The Court of Justice of the European Union (CJEU) has interpreted Article 49 TFEU as prohibiting all national measures, whether discriminatory or not, which are liable to hinder or make less attractive the exercise of the freedom of establishment unless such measures can be justified under a rigorous three-pronged proportionality test.<sup>7</sup>

This study explores corporate takeovers as a particular method of exercising the freedom of establishment. Specifically, it considers whether and, if so, how European takeover law could

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<sup>1</sup> Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law (codification) [2017] OJ L169/46, recital 2.

<sup>2</sup> European Commission, ‘Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies’ COM (2012) 740 final (Commission ‘s 2012 Action Plan on European Company Law), 13.

<sup>3</sup> European Commission, ‘Proposal for a Directive of the European Parliament and of the Council on single-member private limited liability companies’ COM (2014) 212 final.

<sup>4</sup> Consolidated Version of the Treaty on the Functioning of the European Union [2016] OJ C202/47 (TFEU).

<sup>5</sup> This, of course, is subject to the inherent differences between natural and (artificial) legal persons which means that companies may not always be accorded the same treatment as natural persons and vice versa (P Craig and G De Burca, *EU Law: Text, Cases and Materials* (6th edn, OUP 2015) 810).

<sup>6</sup> Case C-106/16 *Polbud — Wykonawstwo* [2017] EU:C:2017:804, para 33; Case C-212/97 *Centros Ltd* [1999] ECR I-1459, para 26.

<sup>7</sup> Case C-55/94 *Gebhard* [1995] ECR I-4165, para 37; Case C-212/97 *Centros Ltd* (n 6), para 34; Case C-400/08 *Commission v Spain* [2011] ECR I-1915, para 64. For details about the proportionality test, see Chapter 4, Section 4.5.2 *infra*.

be reformed to facilitate the exercise of the freedom of establishment in a more efficient manner.

This chapter aims to provide a background for the study. The next section outlines the scope of the study. Section 1.3 states the problem which has instigated the study. Section 1.4 sets out the objectives of the study. Section 1.5 explains the significance of the study. Section 1.6 sets out the methodology. Section 1.7 provides an outline of the chapters that follow. And Section 1.8 concludes.

## 1.2 Scope of the Study

A takeover is an operation whereby a person (legal or natural), termed the ‘acquirer’, purchases sufficient voting rights in a company, termed the ‘target company’, to give the acquirer control of the target company.<sup>8</sup> This means that individuals and companies alike can conduct takeover operations. Thus, the European Takeover Bids Directive applies to takeovers conducted by both individuals and companies.<sup>9</sup> However, in practice, takeovers especially cross-border ones normally involve one company acquiring another.<sup>10</sup> This can be attributed to the financial enormity of such operations. For this reason, but without ruling out the possibility of natural persons participating in cross-border takeovers, this study focuses only on takeovers conducted by companies as opposed to individuals.

That said, we must recall that there are several techniques for conducting takeovers which can be used singly or in combination. These include (1) open market purchases, (2) privately negotiated block purchases, and (3) takeover bids or tender offers.<sup>11</sup> Open market acquisitions are only possible where the target shares are listed on an exchange.<sup>12</sup> Negotiated block purchases occur in *friendly takeovers*, whilst open market purchases and tender offers are normally used as vehicles for *hostile takeovers* (ie takeovers conducted against the will of the incumbent management and/or the controlling shareholder of the target company).<sup>13</sup> However, takeover-specific legislation is normally, albeit not always, confined to companies whose shares or securities are publicly traded.<sup>14</sup> A case in point is the Takeover Bids Directive which applies

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<sup>8</sup> P Davies, K Hopt, and W-G Ringe, ‘Control Transactions’ in R Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 205.

<sup>9</sup> See Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids [2004] OJ L142/12 (Takeover Bids Directive), art 2(1)(c) (defining ‘offeror’ as ‘any natural or legal person governed by public or private law making a bid’).

<sup>10</sup> Davies, Hopt, and Ringe (n 8) 205.

<sup>11</sup> HG Manne, ‘Mergers and the Market for Corporate Control’ (1965) 73 *Journal of Political Economy* 110, 116; Davies, Hopt, and Ringe (n 8) 206.

<sup>12</sup> Davies, Hopt, and Ringe (n 8) 206; Manne (n 11) 116.

<sup>13</sup> M Ventrizzo, ‘Europe’s Thirteenth Directive and U.S. Takeover Regulation: Regulatory Means and Political Economic Ends’ (2006) 41 *Tex Int’l LJ* 171, 181.

<sup>14</sup> Davies, Hopt, and Ringe (n 8) 206.



only to takeover bids for the securities of companies governed by the laws of Member States where all or some of those securities are admitted to trading on a regulated market.<sup>15</sup>

Accordingly, this study only considers takeovers of publicly traded companies conducted through takeover bids. This takeover technique is ‘most apposite when the [target] shares are widely held and there is a chance of a fast increase in market price if the news spreads that there is a heavy buyer in the market for the company’s shares.’<sup>16</sup> In any event, disclosure requirements render it virtually impossible for a prospective acquirer to conceal its intention and purchase a large block of shares before the news leaks out.<sup>17</sup>

EU law requires disclosure to the company and to the market of any acquisition by a person (legal or natural), acting alone or in concert with others, of a proportion of voting rights exceeding certain thresholds.<sup>18</sup> This disclosure obligation extends to all financial instruments which may entitle the holder to acquire voting rights in future such as transferable securities, options, futures, swaps, forward rate agreements, contracts for difference, and any other contracts or agreements with similar economic effects which may be settled physically or in cash.<sup>19</sup> Many Member States have set disclosure thresholds ranging from as low as 2% to 5% of voting rights.<sup>20</sup> In effect, this forces a prospective acquirer ‘to show his hand’,<sup>21</sup> making takeover bids virtually the only viable technique for hostile takeovers.

But, although our study does not consider open market purchases and negotiated block purchases as independent takeover techniques, it must be noted that for strategic reasons<sup>22</sup> prospective bidders tend to commence the takeover process by buying an initial stake (‘toehold’) in the target company.<sup>23</sup> A toehold, like any other portfolio investment, which does not confer control is protected *exclusively* by Article 63 TFEU on free movement of capital.<sup>24</sup>

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<sup>15</sup> Takeover Bids Directive (n 9), art 1.

<sup>16</sup> Manne (n 11) 116.

<sup>17</sup> G Bittlingmayer, ‘The Market for Corporate Control (Including Takeovers)’ (18 March 1998) 5 <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=81808](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=81808)> accessed 27 February 2018.

<sup>18</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38 (as last amended by Directive 2013/50/EU), art 9.

<sup>19</sup> *Ibid*, art 13.

<sup>20</sup> EČ Herc and D Jurić, ‘Disclosure of Beneficial Ownership – From EU Major Shareholdings Directive to EU New Transparency Directive – What Needs to Be Changed in Croatian Securities Markets Act?’ (25 March 2013) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2239280](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239280)> accessed 11 February 2018.

<sup>21</sup> Bittlingmayer (n 17) 5.

<sup>22</sup> See M Lipton, ‘Open Market Purchases’ (1977) 32 *The Business Lawyer* 1321, 1321.

<sup>23</sup> LR Cohen ‘Why Tender Offers? The Efficient Market Hypothesis, the Supply of Stock, and Signaling’ (1990) 19 *The Journal of Legal Studies* 113.

<sup>24</sup> Case C-182/08 *Glaxo Wellcome* [2009] ECR I-8591, para 40; Case C-81/09 *Idrima Tipou AE* [2010] ECR I - 10206, para 48; Case C-367/98 *Commission v Portugal* [2002] ECR I – 4731, paras 44 and 45. The relationship between Articles 49 and 63 TFEU with respect to cross-border takeovers is explained in the next chapter.

### 1.3 Statement of the Problem

Since its adoption on 21 April 2004, the Takeover Bids Directive has been at the centre of severe criticism.<sup>25</sup> Although some positive comments about its impact can be found,<sup>26</sup> the problematic nature of this piece of legislation is beyond doubt. In its report issued on 28 June 2012 in accordance with Article 20 of the Directive, the Commission also acknowledged several deficiencies of the Directive.<sup>27</sup>

Of particular concern here is the wide latitude which the Directive allows in the transposition of the key provisions designed to facilitate takeover bids, especially the so-called ‘board neutrality rule’ (which prohibits the board of the target company from taking any action which could frustrate a bid, unless it has obtained shareholders’ authorisation at a general meeting convened specially to vote on the bid)<sup>28</sup> and the ‘breakthrough rule’ (which seeks to neutralise certain takeover barriers).<sup>29</sup> The optional character of these rules pertaining to takeover defences coupled with the possibility under Article 4(5) for Member States to derogate from the provisions of the Directive ‘*has led to a wide variety of national rules in the field of takeover bids.*’<sup>30</sup>

Although most of the Member States have transposed the board neutrality rule, only a handful of them have transposed the breakthrough rule.<sup>31</sup> And almost half of the Member States, including those that have opted out of both rules but have allowed companies to apply them if they so wish in accordance with Article 12(3) of the Directive, have qualified the application of these rules by a reciprocity exception.<sup>32</sup> This exception entails that companies which may be subject to the board neutrality rule and/or the breakthrough rule, whether by law or based on articles of association, would not be required to observe these rules when they are confronted

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<sup>25</sup> See eg V Edwards, ‘The Directive on Takeover Bids – Not Worth the Paper It’s Written On?’ (2004) 1 ECFR 416; Ventruruzzo, ‘Europe’s Thirteenth Directive’ (n 13) 212; T Papadopoulos, ‘The Mandatory Provisions of the EU Takeover Bid Directive and Their Deficiencies’ (2007) 1 Law & Fin Mkt Rev 525; M Ventruruzzo, ‘Takeover Regulation as a Wolf in Sheep’s Clothing: Taking U.K. Rules to Continental Europe’ (2008) 11 University of Pennsylvania Journal of Business Law 135; P Davies, E-P Schuster, and E van de Whalle de Ghelcke, ‘The Takeover Directive as a Protectionist Tool?’ in U Bernitz and W-G Ringe (eds), *Company Law and Economic Protectionism: New Challenges to European Integration* (OUP 2010).

<sup>26</sup> See eg M Gatti, ‘Optionality Arrangements and Reciprocity in the European Takeover Directive’ (2005) 6 EBOR 553, 561; Ventruruzzo ‘Europe’s Thirteenth Directive’ (n 13) 213; 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’ COM (2012) 347 final (Commission’s 2012 Report), paras 9 and 10.

<sup>27</sup> Commission’s 2012 Report (n 26), paras 15-20.

<sup>28</sup> Takeover Bids Directive (n 9), art 9.

<sup>29</sup> *Ibid.*, art 11.

<sup>30</sup> Commission’s 2012 Report (n 26), para 12 [emphasis added].

<sup>31</sup> See Commission’s 2012 Report (n 26), para 7.

<sup>32</sup> *Ibid.*

with a takeover bid launched by a bidder that is not subject to the same rules. Importantly, the possibility for companies to voluntarily opt into these rules is inconsequential as it is never used in practice.<sup>33</sup>

It follows that the ease (or lack thereof) with which takeover attempts can be thwarted by defensive measures within the internal market varies depending on the Member States in which the bidding and target companies are domiciled. Put another way, the European market for corporate control has effectively been partitioned according to (1) whether the participants in the market are from Member States that have opted into or out of the board neutrality rule and/or the breakthrough rule; and (2) whether the Member States in question have qualified the application of these rules by the reciprocity exception. The situation is exacerbated by other provisions of the Directive such as the ‘mandatory bid rule’ and the ‘sell-out right’ which may be desirable for minority shareholders’ protection but tend to deter takeover bids.<sup>34</sup>

All things considered, the Takeover Bids Directive raises serious efficiency concerns. It is highly questionable whether the Directive in its present form would facilitate the exercise of the freedom of establishment of companies through takeovers in an efficient manner.

Yet, although some provisions of the Directive have been earmarked to be revisited,<sup>35</sup> the Commission has expressed unwillingness to revisit the key provisions on takeover defences, preferring to retain their optional nature for the time being.<sup>36</sup> Importantly, the current action plan on European company law<sup>37</sup> does not incorporate any significant agenda to reform the Takeover Bids Directive. And there seems to be limited progress even in relation to the provisions which the Commission is willing to revisit.<sup>38</sup>

## **1.4 Objectives of the Study**

This study pursues four main objectives. These are:

- 1) to identify the regulatory problems associated with cross-border takeovers conducted through public takeover bids which the law should respond to;
- 2) to examine how the response, or lack of response, by the Takeover Bids Directive to those problems could affect potential bidders’ incentives and/or ability to conduct

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<sup>33</sup> Marccus Partners and Centre for European Policy Studies, ‘The Takeover Bids Directive Assessment Report’ (June 2012) 66 <[http://ec.europa.eu/internal\\_market/company/docs/takeoverbids/study/study\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/takeoverbids/study/study_en.pdf)>accessed 2 March 2018.

<sup>34</sup> Ibid, 29.

<sup>35</sup> Commission’s 2012 Report (n 26), para 23, 24, 25, and 27.

<sup>36</sup> Ibid, para 26.

<sup>37</sup> Commission ‘s 2012 Action Plan on European Company Law (n 2).

<sup>38</sup> See also European Parliament Resolution of 21 May 2013 on the application of Directive 2004/25/EC on takeovers bids (2012/2262(INI)) [2016] C55/01.

successful cross-border takeover operations;

- 3) to identify specific rules of the Takeover Bids Directive which may need to be improved to encourage potential bidders to conduct cross-border takeovers; and
- 4) to provide recommendations on how the Takeover Bids Directive could be improved to facilitate, in a more efficient manner, the exercise of the freedom of establishment of companies through takeovers.

## 1.5 Significance of the Study

Although there are several methods by which companies can exercise the freedom of establishment, this study adds a valuable voice to a subject which is pertinent to the attainment of an efficient internal market. Takeovers play a peculiar role in the grand scheme of things. They constitute a special market: the market for corporate control.<sup>39</sup> The market for corporate control; that is, the arena in which corporate management teams compete for the rights to manage corporate resources<sup>40</sup> is itself an integral part of the internal market.<sup>41</sup>

The proposition here is that where the incumbent management's performance is optimal, shareholders are unlikely to sell their shares to another management team, unless it is overbidding.<sup>42</sup> They are likely to sell their shares only if the incumbent management is inefficient.<sup>43</sup> The market for corporate control, particularly hostile takeovers, therefore performs two crucial functions in the structure of corporate law. First, a takeover can maximise the value of the target company by replacing inefficient managers with more efficient ones.<sup>44</sup> Second, the mere 'threat' that a hostile takeover bid can be made in future operates as an incentive for incumbent managers to run the affairs of 'their' companies more efficiently, to prevent attracting hostile bidders.<sup>45</sup> Ultimately, this does not only ameliorate management–shareholder agency problems which are endemic in corporate governance. It also enhances economic efficiency since, as noted above, companies are key economic players.

Quite apart from these two disciplinary functions of takeovers, the integration of companies

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<sup>39</sup> See Manne (n 11); JC Coffee 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1145; EB Rock 'Antitrust and the Market for Corporate Control' (1989) 77 California Law Review 1367; C Bradley 'Corporate Control: Markets and Rules' (1990) 53 MLR 170.

<sup>40</sup> MC Jensen and RS Ruback, 'The Market for Corporate Control: The Scientific Evidence' (1983) 11 Journal of Financial Economics 5, 6.

<sup>41</sup> T Papadopoulos, 'Infringements of Fundamental Freedoms within the EU Market for Corporate Control' (2012) 2 ECFR 221, 232-33.

<sup>42</sup> R Whish and D Bailey, *Competition Law* (8th edn, OUP 2015) 858.

<sup>43</sup> *Ibid.*

<sup>44</sup> M Kahan and M Klausner, 'Lockups and the Market for Corporate Control' (1996) 48 Stanford Law Review 1539, 1551.

<sup>45</sup> *Ibid.*

resulting from takeover operations might also lead to synergistic gains by way of economies of scale and economies of scope.<sup>46</sup> These benefits may not be fully realised in the absence a regulatory framework that efficiently stimulates takeovers.

The significance of this study therefore does not only lie in provoking further discourse on a thorny but indispensable issue which the EU legislature is largely reluctant to reopen. It also lies in the attempt to propose optimal solutions informed by two important considerations: (1) the need to facilitate market integration through the freedom of establishment of companies, and (2) the need to enhance economic efficiency through a market-based corporate governance mechanism ie takeovers.

## **1.6 Methodology**

To gain insight into the problem at hand, this study closely examines the letter of the Takeover Bids Directive. A teleological approach is adopted in this regard. That is, the relevant provisions are examined in the light of the primary purpose for which the Directive was adopted.

The examination is grounded in relevant economic theory, specifically the economic considerations which should inform the crafting of takeover rules. This is done in an attempt to find economically efficient solutions. Due care is taken to balance any conflicting interests and variables. The reasons that led the EU legislature to compromise on certain key provisions of the Directive are also considered in proposing solutions that would represent a ‘more efficient compromise’.

## **1.7 Outline of Chapters**

The remainder of this study is organised as follows. The next chapter provides further context by identifying the primary objective of the Takeover Bids Directive and explaining why corporate takeovers within the EU legal framework fall under the umbrella of the freedom of establishment. Chapter 3 considers the mechanics of takeovers conducted through public bids, highlighting the main regulatory problems which these transactions tend to engender. This is done in pursuit of the first objective of the study. Guided by relevant economic considerations, Chapter 4 critically examines how the Takeover Bids Directive responds to the problems that are identified in Chapter 3. This is done in pursuit of the second and third objectives. Finally, in pursuit of the fourth objective, Chapter 5 concludes by making recommendations on how the Directive could be improved, to facilitate the exercise of the freedom of establishment of

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<sup>46</sup> Davies, Schuster, and van de Walle de Ghelcke (n 25) 118.

companies through takeovers in a more efficient manner.

## **1.8 Conclusion**

This chapter has set the scene for our study. A key point to keep in mind is that the study seeks to evaluate the Takeover Bids Directive from the perspective of the freedom of establishment of companies within the EU legal framework, specifically Articles 49 and 54 TFEU. The study has been instigated by apparent deficiencies of the Takeover Bids Directive which raise some doubt as to whether the Directive would efficiently facilitate the exercise of the freedom of establishment through corporate takeovers.

## 2 Takeovers and the Freedom of Establishment

### 2.1 Introduction

The Takeover Bids Directive<sup>1</sup> was adopted on the legal basis of what is now Article 50 TFEU,<sup>2</sup> a provision which empowers the European Parliament and the Council to adopt directives in order to attain freedom of establishment as regards a particular activity in accordance with Article 49 TFEU. However, one of the objectives of the Takeover Bids Directive is to reinforce ‘the single market, by enabling free movement of capital’.<sup>3</sup> The freedom of establishment and free movement of capital are two distinct fundamental freedoms of the EU. Whilst the freedom of establishment is enshrined in Article 49 TFEU, free movement of capital is protected by Article 63 TFEU. Importantly, the latter applies to third countries (ie non-EU member countries) but the former does not.

This chapter seeks to briefly explain the overlap between the two freedoms in relation to corporate takeovers and clarify why this study examines the Takeover Bids Directive in the light of the freedom of establishment rather than free movement of capital. In doing so, the chapter proceeds as follows. The next section considers the overlap between the two freedoms. Section 2.3 highlights the lack of definite guidance from the CJEU as to how this overlap should be treated. Section 2.4 explains why this study postulates that corporate takeovers constitute a particular method of exercising the freedom of establishment. Section 2.5 then concludes.

### 2.2 The Overlap with Free Movement of Capital

The scope of the freedom of establishment of companies is broad. The CJEU has interpreted Article 49 TFEU as covering all measures which permit or even merely facilitate access to a Member State and the pursuit of an economic activity in that state, by allowing persons from another Member State to participate in the economic life of the country effectively and under the same conditions as national operators.<sup>4</sup> Thus, according to the CJEU, cross-border merger operations, ‘*like other company transformation operations*’, constitute particular methods of exercising the freedom of establishment.<sup>5</sup> It is thus generally believed that, other than mergers, corporate restructuring activities such as takeovers and divisions also fall within the scope of

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<sup>1</sup> Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids [2004] OJ L142/12 (Takeover Bids Directive).

<sup>2</sup> Consolidated Version of the Treaty on the Functioning of the European Union [2016] OJ C202/47 (TFEU).

<sup>3</sup> 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’ COM (2012) 347 final (Commission’s 2012 Report), para 3.

<sup>4</sup> Case C-411/03 *SEVIC Systems AG* [2005] ECR I-10805, para 18.

<sup>5</sup> *Ibid*, para 19 (emphasis added).

Article 49 TFEU.<sup>6</sup>

To elaborate, a successful cross-border takeover operation allows an economic operator from one Member State (A) to access another Member State (B), to pursue an economic activity in Member State B. Thanks to such an operation, instead of exercising the right of secondary establishment by setting up a new branch, subsidiary, agency etc<sup>7</sup> in terms of Article 49 TFEU, a company can ‘simply’ acquire a controlling stake in the capital of another company based in Member State B. The acquired company can then be retained in its original corporate form as a subsidiary of the acquiring company or the two companies can be ‘merged’, converting the acquired company into a branch.

Thus, the CJEU has reiterated on many occasions that holdings in the capital of a company established across borders within the EU, where such holdings allow the investor to exercise definite influence over the company’s decisions and to determine its activities, fall within the ambit *ratione materiae* of the freedom of establishment.<sup>8</sup> By Article 54 TFEU, this applies with equal force whether the investor in question is a national of a Member State or a legal entity. The only proviso with respect to the latter is that the legal entity in question must have been formed in accordance with the law of a Member State and must have its registered office, central administration or principal place of business somewhere within the EU.

That takeovers constitute an attractive business growth strategy – especially in a cross-border context – is undoubtable. Getting a new subsidiary or branch off the ground in a foreign country normally entails significant financial risk-taking and, therefore, is likely to be more daunting than taking over an already established business. It is thus rather ironical that no explicit reference is made to the freedom of establishment of companies in the Takeover Bids Directive, despite the Directive having been adopted pursuant to Article 50 TFEU.<sup>9</sup> However, the fact that the Directive refers to Article 50 as its legal basis implicitly means that it was adopted to facilitate the exercise of the freedom of establishment through corporate takeovers.

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<sup>6</sup> See eg T Papadopoulos, ‘EU Regulatory Approaches to Cross-Border Mergers: Exercising the Right of Establishment’ (2011) 36 *European Law Review* 71, 78; *European Model Companies Act 2017 (EMCA)* 289. The EMCA was drafted by a consortium of prominent company law scholars from 22 Member States.

<sup>7</sup> The reference in art 49 TFEU to ‘agencies, branches or subsidiaries’ is illustrative rather than exhaustive. See Case 205/84 *Commission v Germany* [1986] ECR 3755, para 21 (holding that an office managed by the undertaking’s own staff or by a person who is independent but authorised to act on a permanent basis for the undertaking, as would be the case with an agency, constitutes an exercise of the freedom of establishment).

<sup>8</sup> See eg Case C-251/98 *Baars* [2000] ECR I-2787, para 22; Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* [2006] ECR I-7995, para 31; Case C-524/04 *Test Claimants in the Thin Cap Group Litigation* [2007] ECR I-2107, para 27; Case C-112/05 *Commission v Germany* [2007] ECR I-8995, para 13; Case C-326/07 *Commission v Italy* [2009] ECR I-2291, para 34; Case C-81/09 *Idrma Tipou AE* [2010] ECR I -10206, para 47.

<sup>9</sup> See also Commission’s 2012 Report (n 3), para 3. The Commission does not make explicit reference to the freedom of establishment in its summary of the main objectives of the Directive.



In keeping with the case law of the CJEU, this ought to be the overall objective of the Directive albeit it is legally competent for the Directive to pursue other objectives, provided the overall objective is clearly disclosed.<sup>10</sup> In fact, according to the Commission, one of the objectives of the Directive is to facilitate takeover bids.<sup>11</sup> This chimes with the objective of facilitating the freedom of establishment since facilitation of takeover bids is essentially facilitation of the exercise of the freedom of establishment of companies through takeovers.

Interestingly, although the freedom of establishment is not expressly mentioned in the Takeover Bids Directive, the Directive refers to free movement of capital in its recitals.<sup>12</sup> And according to the Commission, one of the other objectives of the Directive is to facilitate free movement of capital.<sup>13</sup> Indeed, there can be no takeover without some movement of capital. As the CJEU noted in *Casati* ‘freedom to move certain types of capital is, in practice, a precondition for the effective exercise of other freedoms guaranteed by the Treaty, in particular the right of establishment.’<sup>14</sup> This holds true in relation to takeover operations. As we have noted in Section 1.2, a takeover is about purchasing voting rights in a company, and the consideration for the purchase invariably takes the form of cash or securities of the purchaser or a combination of both.<sup>15</sup> This is where the movement of capital comes in.

Therefore, takeovers involve an exercise of two freedoms: freedom of establishment and free movement of capital, protected respectively by Articles 49 and 63 TFEU. This begs the question whether the two freedoms apply in parallel or whether one is prioritised over the other.

### **2.3 Freedom of Establishment or Free Movement of Capital or Both?**

The CJEU’s case law on the invocation of these freedoms in situations where they overlap in relation to holdings or acquisitions of corporate shares is inconsistent.<sup>16</sup> Three strands of cases can be identified in this regard. The first consists of cases in which, upon finding a restriction on the freedom of establishment, the CJEU deemed it unnecessary to consider whether the free movement of capital had also been infringed.<sup>17</sup> In a second strand of cases, the

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<sup>10</sup> Case C-380/03 *Germany v European Parliament and Council* [2006] ECR I-11573, para 108 (see also the cases cited therein).

<sup>11</sup> Commission’s 2012 Report (n 3), para 3. See Takeover Bids Directive (n 1), recital 18.

<sup>12</sup> Takeover Bids Directive (n 1), recital 20.

<sup>13</sup> Commission’s 2012 Report (n 3), para 3.

<sup>14</sup> Case 203/80 *Casati* [1981] ECR 02595, para 8.

<sup>15</sup> See Takeover Bids Directive (n 1), art 5(5); T Papadopoulos, ‘Infringements of Fundamental Freedoms within the EU Market for Corporate Control’ (2012) 2 ECFR 221, 222.

<sup>16</sup> See S Hemels and others ‘Freedom of Establishment or Free Movement of Capital: Is there an Order of Priority?’ (2010) 1 EC Tax Review 19; Papadopoulos, ‘Infringements of Fundamental Freedoms’ (n 15) 230-32.

<sup>17</sup> Case C-200/98 *X AB and YAB* [1999] ECR I-8261, para. 30; Joined cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and Others (C-397/98), Hoechst AG And Hoechst (UK)Ltd (C 410/98) v Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-01727; Case C-251/98 *Baars* [2000] ECR I-2787.

court adopted the opposite approach, deeming it unnecessary to examine whether there had been a restriction on the freedom of establishment upon finding a restriction on the free movement of capital.<sup>18</sup> The third approach concerns cases in which the two freedoms were invoked concurrently, without prioritising one over the other.<sup>19</sup>

Although these inconsistent approaches might not have affected the outcomes of the cases in question, clear guidance from the CJEU on how the overlap between the freedom of establishment and the free movement of capital should be treated is needed. It is needed because, whereas the freedom of establishment cannot be relied upon in third country situations, the free movement of capital can.<sup>20</sup> As concerns takeovers, for example, a company domiciled in a third country can launch a takeover bid for a company domiciled in the EU. In the event of a dispute in this scenario, the court would probably invoke Article 63 TFEU rather than Article 49 TFEU which does not apply to third countries. But for now, one can only speculate.

Even some national courts have arrived at contradictory conclusions on how the overlap between the two freedoms should be treated. Thus, Hemels and others believe that the questions as to whether these freedoms should be applied in parallel or whether one should take priority over the other (and the circumstances when this should happen) are not *acte clair/acte éclairé*.<sup>21</sup> In accordance with *CILFIT*,<sup>22</sup> they consider that national courts should no longer decide these questions without seeking a preliminary ruling from the CJEU, until the CJEU makes clear and consistent pronouncements on them.

## 2.4 Why Freedom of Establishment?

Whilst the above questions are still lingering, this study restricts itself to the freedom of establishment for three reasons. First, as we have noted above, the Takeover Bids Directive – the subject matter of this study – was adopted on the legal basis of Article 50 TFEU pertaining to freedom of establishment.

Second, notwithstanding the fact that any takeover operation is invariably predicated on the movement of capital (ie the purchase and transfer of voting securities of a company from

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<sup>18</sup> Case C-302/97 *Konle* [1999] ECR 3099; Case C-58/99 *Commission v Italy* [2000] ECR I-3811; Case C-367/98 *Commission v Portugal* [2002] ECR I-4731; Case C-483/99 *Commission v France* [2002] ECR I-4781; Case C-503/99 *Commission v Belgium* [2002] ECR I-4809; Case C-463/00 *Commission v Spain* [2003] ECR I-4581; Case 98/01 *Commission v United Kingdom* [2003] ECR I-4641; Case C-174/04 *Commission v Italy* [2005] ECR I-4933; Joined Cases C-282 and C-283/04 *Commission v Netherlands* [2006] ECR I-9141; Case C-112/05 *Commission v Germany* [2007] ECR I-8995. See also A Landsmeer ‘Movement of Capital and Other Freedoms’ [2001] 28 Legal Issues of Economic Integration 57, 64.

<sup>19</sup> Case C-81/09 *Idrima Tipou* (n 8), para 49; Case C-326/07 *Commission v Italy* (n 8), para 36.

<sup>20</sup> See art 63 TFEU; Hemels and others (n 16).

<sup>21</sup> Hemels and others (n 16).

<sup>22</sup> Case 283/81 *SRL CILFIT — in liquidation — and 54 Others v Ministry of Health* [1982] ECR 3417, para 16.

existing shareholder(s) to the acquirer), the significance of takeovers does not necessarily lie in the transfer of securities. It lies in the fact that they are control transactions.<sup>23</sup> The very essence of a takeover operation is to transfer control (not mere securities) of the acquired company to the acquirer. As earlier stated, this is what brings takeovers within the realm of the freedom of establishment as the acquirer can exercise definite influence over the acquired company. Thus, in a cross-border situation, this allows the acquirer to participate on a permanent basis in the economic life of a Member State other than its own.

The third reason is simply that this study is interested in corporate takeovers only insofar as they constitute a particular method of exercising the freedom of establishment.

## **2.5 Conclusion**

Technically, cross-border takeover operations within the EU are protected by both Article 49 TFEU on freedom of establishment and Article 63 TFEU on free movement of capital. But it remains unclear whether these two economic freedoms should be applied in parallel or whether one should be prioritised over the other. None the less, for the reasons given in the preceding section, this study only concerns itself with the freedom of establishment.

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<sup>23</sup> PL Davies (ed), *Gower & Davies: The Principles of Modern Company Law* (8th edn, Sweet & Maxwell 2008) 961-62; P Davies, K Hopt, and W-G Ringe, 'Control Transactions' in R Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017).

## 3 Takeover Bids and Regulatory Problems

### 3.1 Introduction

This chapter seeks to highlight the mechanics of takeovers conducted through public bids. It begins by explaining in Section 3.2 what is meant by ‘takeover bids’. Section 3.3 then considers why it is necessary to regulate the conduct of takeover bids at EU level in order to foster the freedom of establishment through an efficient and active market for corporate control. Two main economic problems associated with the corporate form are identified in this regard, namely agency problems and coordination problems. Sections 3.4 and 3.5 in turn examine these problems respectively. Section 3.6 concludes.

### 3.2 Takeover Bids and Tender Offers

The terms ‘takeover bid’ and ‘tender offer’ are often used interchangeably in literature. However, the latter bears a narrower meaning than the former. To be precise, a tender offer is a specific species of a public takeover bid.<sup>1</sup> The US Securities and Exchange Commission (SEC) has identified eight characteristics of a typical tender offer.<sup>2</sup> First, a bidder makes an active and widespread solicitation of public shareholders for shares of the target company. Second, the solicitation is made for a substantial percentage of the target company’s shares. Third, an offer to purchase the target shares is made at a premium above the prevailing market price. Fourth, the terms of the offer are firm rather than negotiable. Sixth, the offer is contingent on the tender of a fixed minimum number of shares. Sixth, the offer remains open for a limited period of time. Seventh, the target shareholders are subjected to pressure to sell their shares. Eighth, the bidder publicly announces its intention to gain control of the target company and accumulates a large amount of the target company’s shares before or at the time of such announcement (subject to the difficulty arising from disclosure requirements as noted above<sup>3</sup>).

The European Takeover Bids Directive<sup>4</sup> does not provide a definition of the term ‘tender offer’. Instead, it defines a ‘takeover bid’ as a public offer ‘made to the holders of the securities of a company to acquire all or some of those securities, whether mandatory or voluntary, which follows or has as its objective the acquisition of control of the [target] company in accordance

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<sup>1</sup> MH Cohen, ‘Tender Offers and Takeover Bids’ (1968) 23 *The Business Lawyer* 611, 611.

<sup>2</sup> JR Evans, ‘Tender Offers: An SEC Perspective’ (SEC, 22 June 1979) 16-17; LR Cohen ‘Why Tender Offers? The Efficient Market Hypothesis, the Supply of Stock, and Signaling’ (1990) 19 *The Journal of Legal Studies* 113, 115-16. See also *Hoover v Fuqua Industries, Inc.*, C. 79-1062A (N.D. Ohio June 11, 1979); *Wellman v Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979).

<sup>3</sup> Section 1.2 Thus, this characteristic is not always present. See eg *Wellman v Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979).

<sup>4</sup> Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids [2004] OJ L142/12 (Takeover Bids Directive).

with national law.<sup>5</sup> To be sure, this definition is broad. It encompasses tender offers as envisaged by the SEC, as well as any other bids for corporate control which may be addressed directly to shareholders of the target company in accordance with national law.

Takeover bids and, more specifically, tender offers can thus be contrasted with other techniques for acquiring corporate control, particularly mergers. The fact that a takeover bid is addressed to shareholders rather than to corporate management means that a bidder can circumvent uncooperative incumbents and deal directly with the target shareholders, in the absence of a corporate decision or approval by the target board of directors.<sup>6</sup> This is what makes hostile takeovers possible. By contrast, a statutory merger can only be consummated after management of both (or all) merging companies has negotiated and agreed on the terms of the transaction.<sup>7</sup>

### 3.3 The Need for Regulation

But why are takeover bids subject to regulation at EU level? We must recall that '[t]he contractual view of the corporation opposes regulation if the market economy achieves the efficient outcome without intervention.'<sup>8</sup> Regulatory intervention in the operation of the market for corporate control can therefore only be justified by a clear need to address identifiable market failures.<sup>9</sup> Importantly, the use of legislative competences by the EU is governed by the principles of subsidiarity and proportionality as set out in Article 5 of the Treaty on European Union (TEU).<sup>10</sup> Thus, in an area such as that of corporate takeovers which does not fall within the exclusive competence of the EU, regulatory intervention by the EU legislature would only be warranted if, and insofar as, the objectives of such regulation cannot be sufficiently achieved by Member States, but can rather be better achieved at EU level. And any such intervention cannot go beyond what is necessary to achieve the objective(s) in view.

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<sup>5</sup> Ibid, art 2(1)(a).

<sup>6</sup> M Burkart 'Economics of Takeover Regulation' (Stockholm School of Economics, 1999) 3 <[http://ecgi.org/takeovers/documents/academic/papers/burkart\\_1999.pdf](http://ecgi.org/takeovers/documents/academic/papers/burkart_1999.pdf)> accessed 15 March 2018; P Davies, K Hopt, and W-G Ringe, 'Control Transactions' in R Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 205.

<sup>7</sup> JJ Johnson and M Siegel, 'Corporate Mergers: Redefining the Role of Target Directors' (1987) 136 *University Pennsylvania Law Review* 315, 317. See Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law (codification) [2017] OJ L169/46, arts 91 and 122; Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE) [2001] OJ L294/1, art 20 (setting out specific terms which management must agree on to consummate a statutory merger in the EU).

<sup>8</sup> C Van der Elst and L Van den Steen, 'Opportunities in the Merger and Acquisition Aftermarket: Squeezing Out and Selling Out' in GN Gregoriou and L Renneboog (eds), *Corporate governance and Regulatory Impact on Mergers and Acquisitions* (Elsevier 2007) 194.

<sup>9</sup> YZ Stern 'A General Model for Corporate Acquisition Law' (2001) 26 *Journal of Corporation Law* 675, 716.

<sup>10</sup> Consolidated Version of the Treaty on European Union [2016] OJ C202/13 (TEU), art 5.

Recital 25 of the Takeover Bids Directive explains that EU rules on takeover operations are necessary in order to establish minimum guidelines for the conduct of takeover bids and to ensure an adequate level of protection for holders of securities throughout the Union. According to this recital, these objectives cannot be sufficiently achieved by Member States because of the need for transparency and legal certainty in the case of cross-border takeover operations and acquisitions of corporate control and can, therefore, be better achieved at EU level.

Indeed, minimum guidelines for the conduct of takeover bids and for the protection of shareholders and other stakeholders in the context of takeover operations are necessary to foster the freedom of establishment through an efficient market for corporate control. The efficiency of the market for corporate control might be impeded by multifaceted market failures, which are accentuated in a cross-border context due to a range of socioeconomic variables and divergent political ideologies across states. For simplicity, these failures can be divided into two broad categories of problems associated with the corporate form which takeover regulation the world over seeks to address, namely *agency problems* and *coordination problems*.<sup>11</sup>

### 3.4 Agency Problems

In corporate law and economics scholarship, the term ‘agency problems’ refers to various conflicts of interests which tend to arise between corporate constituencies.<sup>12</sup> Some argue that this is a misnomer as reference to some corporate constituencies as agents of others is inapposite.<sup>13</sup> However, the broadest meaning of the term as used by economists rather than by lawyers is adopted here. To be specific, all conflicts of interests which may arise in the corporate context – whenever one party, loosely termed the ‘principal’, relies upon actions taken by another party, loosely termed the ‘agent’, to advance the principal’s welfare<sup>14</sup> – shall be deemed agency problems for our purposes.

That said, we may recall from Section 1.5 that the potential economic benefits of takeovers derive in part from ameliorating agency problems which are endemic in corporate governance, by disciplining management (and perhaps controlling shareholders) and, in turn, by enabling efficient allocation of corporate resources. But there is a paradox. Takeovers themselves are

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<sup>11</sup> Marccus Partners and Centre for European Policy Studies, ‘The Takeover Bids Directive Assessment Report’ (June 2012) 275 <[http://ec.europa.eu/internal\\_market/company/docs/takeoverbids/study/study\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/takeoverbids/study/study_en.pdf)> accessed 2 March 2018; Davies, Hopt, and Ringe (n 6) 207.

<sup>12</sup> J Armour, H Hansmann, and R Kraakman, ‘Agency Problems and Legal Strategies’ in R Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 29.

<sup>13</sup> See eg MM Blair and LA Stout, ‘Specific Investment: Explaining Anomalies in Corporate Law’ (2006) 31 *Journal of Corporate Law* 719 (arguing that corporate managers are not shareholders’ agents).

<sup>14</sup> Armour, Hansmann, and Kraakman (n 12) 29. See also SA Ross, ‘The Economic Theory of Agency: The Principal’s Problem’ (1973) 63 *The American Economic Review* 134; EF Fama and MC Jensen ‘Agency Problems and Residual Claims’ (1983) 26 *The Journal of Law and Economics* 327.

subject to agency problems.<sup>15</sup> To be specific, takeovers may engender conflicts of interests which could impair the efficiency of the market for corporate control. These conflicts tend to arise between: (1) corporate managers and shareholders; (2) controlling and non-controlling shareholders; and (3) bidders and non-shareholder stakeholders, particularly employees and creditors.<sup>16</sup>

The exact nature of these conflicts in any given transaction largely depends on the shareholder distribution of the company concerned; that is, whether it has a concentrated ownership structure (with a controlling shareholder) or a dispersed ownership structure (without a controlling shareholder).<sup>17</sup>

### **3.4.1 Management vs Shareholders**

In widely held companies, takeovers engender conflicts of interests between corporate management – more specifically, the board of directors – and shareholders as a class.<sup>18</sup> The de facto control of such companies is essentially in the hands of corporate managers whose incentives are often not aligned with shareholders' interests. The management–shareholder conflict is exacerbated by information and coordination costs which inhibit dispersed shareholders' ability to engage in collective action, to monitor managerial opportunism.<sup>19</sup> In the face of a takeover bid, this conflict may arise in the target company as well as in the bidding company.

#### *(a) Agency conflicts from the perspective of the target company*

Consider potential agency conflicts from the perspective of the target company first. We may recall from the characteristics of tender offers listed above that a cash tender offer typically presents shareholders with an opportunity to sell their shares 'quickly and at a premium over the market price.'<sup>20</sup> Importantly, a tender offer also presents the target shareholders with an opportunity to exit an inefficiently managed company, to invest their capital elsewhere. Thus, assuming the bidder would be a more efficient user of the target assets than the incumbent management, the transaction could be beneficial not only to the target shareholders but also to the bidder and to the economy as a whole. But two inverse possibilities might defeat the actualisation of the potential benefits of the transaction.

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<sup>15</sup> E Berglöf and M Burkart, 'European Takeover Regulation' (2003) 18 *Economic Policy* 171, 176.

<sup>16</sup> Davies, Hopt, and Ringe (n 6) 207-10.

<sup>17</sup> *Ibid.*, 207.

<sup>18</sup> *Ibid.*

<sup>19</sup> Armour, Hansmann, and Kraakman (n 12) 30.

<sup>20</sup> FH Easterbrook and DR Fischel, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 *Harvard Law Review* 1161, 1161.

First; concerned about protecting their jobs and perquisites as de facto controllers, the target board members might oppose the offer under the pretext that the premium is insufficient and value-decreasing and/or that the company would be harmed by the bidder<sup>21</sup> (for ease of reference, let us term this possibility ‘*managerial entrenchment*’<sup>22</sup>). The target board might even proceed to implement some measures to thwart the takeover. A myriad of defensive tactics exists which the board could choose from in this regard,<sup>23</sup> some of which (such as the sale of the crown jewels) entail making the target company worse off. These defences may be used singly or in combination, and some (such as poison pills, poison debt, staggered boards, etc) can be adopted well before a bid is imminent.<sup>24</sup>

Depending on their potency, defensive tactics (both pre-bid and post-bid) might make it more difficult, more expensive and thus less profitable, or even totally impossible to conduct a successful hostile takeover.<sup>25</sup> Inefficient managers might use such tactics to entrench themselves in the target company and perpetuate their inefficiency. In fact, the mere prospect of the target board adopting defensive measures can operate as a disincentive ex ante for a potential bidder to launch a bid. Breaking down a takeover defence in a hostile situation can be a costly venture which any frugal bidder would seek to avoid.

Even in the absence of pre-bid defences, a typical tender offer involves substantial transaction sunk costs<sup>26</sup> such that a prospective bidder would be unwilling to incur these costs unless it is assured that the target board would not attempt to frustrate the transaction. A bidder that decides to brave defences must necessarily be willing to incur additional costs in this connection including, probably, ‘overpaying’ in premia hence allocating its surplus from the transaction to the target shareholders. The bidder may also lose the target to another bidder such as a white knight, if the target management is unable to thwart the transaction altogether.

Second; instead of attempting to entrench themselves, the target directors in furtherance of their personal interests might encourage unsuspecting shareholders to tender their shares for

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<sup>21</sup> Easterbrook and Fischel (n 20) 1161.

<sup>22</sup> See by analogy E Rock and others, ‘Fundamental Changes’ in R Kraakman et al (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 185.

<sup>23</sup> Davies, Hopt, and Ringe (n 6) 207-08.

<sup>24</sup> see J Winter and others, ‘Report of the High-Level Group of Company Law Experts on Issues Related to Takeover Bids’ (10 January 2002, Brussels), annex 4 (setting out both major pre-bid and post-bid defences). See also SA Hochman and OD Folger, ‘Deflecting Takeovers: Charter and By-Law Techniques’ (1979) 34 *The Business Lawyer* 537; CM Nathan and M Sobel, ‘Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids’ (1980) 35 *The Business Lawyer* 1545; Easterbrook and Fischel (n 20).

<sup>25</sup> Easterbrook and Fischel (n 20) 1161-62.

<sup>26</sup> G Meeks and JG Meeks, ‘The Loser’s Curse: Accounting for the Transaction Costs of Takeover and the Distortion of Takeover Motives’ (2001) 37 *ABACUS* 389; R Smiley, ‘Tender Offers, Transactions Costs and the Theory of the Firm’ (1976) 58 *The Review of Economics and Statistics* 22, 30; LR Cohen (n 2); FH Easterbrook and DR Fischel ‘Auctions and Sunk Costs in Tender Offers’ (1982) 35 *Stanford Law Review* 1.



sale under the pretext that the premium is sufficient and value-maximising when in fact the opposite is true (for ease of reference, let us term this possibility ‘*managerial nest-feathering*’<sup>27</sup>). The target directors may do so, for example, in order to reap handsome compensation in golden parachutes or to benefit the bidding consortium of which they are part.<sup>28</sup> Indeed, ‘[w]hen we find incumbents recommending a control change, it is generally safe to assume that some side payment is occurring.’<sup>29</sup>

Such managerial nest-feathering, just like managerial entrenchment through takeover defences, might lead to inefficiency. Of course, managerial entrenchment detracts from the efficiency of the market for corporate control by discouraging potential bidders from making bids, *ex ante*, and by frustrating bids when they are launched, *ex post*. Likewise, managerial nest-feathering leads to inefficiency if it has the effect of converting seller surplus into buyer surplus and vice versa; or if it leads to a transfer of control to an inefficient bidder, such as a management-serving white knight.

It is therefore necessary to protect shareholders from both managerial entrenchment and managerial nest-feathering if the potential disciplinary and economic benefits of the market for corporate control are to be meaningfully realised. Shareholder protection in the context of takeovers also has an economic rationale *vis-à-vis* the cost of capital. Absent sufficient protection, potential investors in the stock market would demand substantial discounts when buying shares or completely avoid investing in the market in view of the risk of making a loss or being excluded from participating in takeover gains in the event of a takeover.<sup>30</sup>

*(b) Agency conflicts from the perspective of the bidding company*

Consider in turn potential agency conflicts from the perspective of the bidding company. Managerial nest-feathering is exacerbated in a widely held target company if the bidder’s management is also driven by ulterior motives other than putting the target assets to more efficient use or exploiting financial and operational synergies.<sup>31</sup> Managers of corporate bidders sometimes pursue acquisitions in order to gain ‘prestige from managing larger firms, receive

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<sup>27</sup> See by analogy Rock and others (n 22) 185.

<sup>28</sup> Davies, Hopt, and Ringe (n 6) 208.

<sup>29</sup> HG Manne, ‘Mergers and the Market for Corporate Control’ (1965) 73 *Journal of Political Economy* 110, 118.

<sup>30</sup> Burkart (n 6): See R La Porta and others, ‘Legal Determinants of External Finance’ (1997) 52 *Journal of Finance* 1131 (confirming empirically that the valuation and the breadth of capital markets, both equity and debt, increases with the quality of the legal protection of investors).

<sup>31</sup> See DM Depamphilis, *Mergers, Acquisitions, and Other Restructuring Activities: An Integrated Approach to Process, Tools, Cases, and Solutions* (6th edn, Elsevier 2012) 5-13; U Weitzel & KJ McCarthy, ‘Firm Size – When Bigger Isn’t Always Better: A Study of Merger and Acquisitions by Small and Medium Enterprises’, in KJ McCarthy and W Dolfsma, *Understanding Mergers and Acquisitions in the 21st Century: A Multidisciplinary Approach* (Palgrave Macmillan 2013) 81-85 (detailing both value-enhancing and value-destroying theories of corporate acquisitions).

more perks, be better compensated, and be safer from hostile takeovers.<sup>32</sup> Empire-building attempts aimed at eliminating competing firms from the market which may not be objectionable to the bidder's shareholders could nonetheless produce negative economic effects.<sup>33</sup>

In pursuit of their self-interests, the bidding managers may 'collude' with self-serving target managers to persuade unsuspecting shareholders to tender their shares for sale at a suboptimal price. Or as earlier alluded to, they may overpay the target shareholders in premia and 'bribe' the target managers with golden parachutes or other incentives, at the expense of the shareholders of the bidding company and overall efficiency.

Empirical studies on takeovers have consistently revealed that target shareholders' gains from takeover activity tend to be economically and statistically significant.<sup>34</sup> By contrast, gains to the shareholders of the bidding company tend to be statistically insignificant, unaffected or even negative,<sup>35</sup> albeit aggregated profits and losses of all the shareholders involved tend to be significantly positive.<sup>36</sup> This disequilibrium in the distribution of takeover gains between shareholders has been partly attributed to agency problems between management and shareholders in widely held bidding companies.<sup>37</sup> That is, corporate managers pursue acquisitions to satisfy personal interests rather than to put the target assets to more efficient use or exploit synergies for the benefit of shareholders. However, empirical evidence on this agency hypothesis is inconsistent.<sup>38</sup>

Indeed, other than overpayment resulting from agency conflicts in the bidding company, there are several theories that have been used to explain why many takeovers when viewed in retrospect from the perspective of the bidder have turned out to have been an economic

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<sup>32</sup> LL Barger and others, 'Why do Private Acquirers Pay So Little Compared to Public Acquirers?' (2008) 89 *Journal of Financial Economics* 375, 376.

<sup>33</sup> This may trigger the application of competition law, a distinct field of law which is outside the scope of this study.

<sup>34</sup> R Romano, 'A Guide to Takeovers: Theory, Evidence, and Regulation' (1992) 9 *Yale Journal on Regulation* 119, 122; M Martynova and L Renneboog, 'A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?' (2008) 32 *Journal of Banking & Finance* 2148, 2153; KJ Hopt, 'Takeover Defenses in Europe: A Comparative, Theoretical and Policy Analysis' (2014) 20 *Columbia Journal of European Law* 249, 252.

<sup>35</sup> BS Black, 'Bidder Overpayment in Takeovers' (1989) 41 *Stanford Law Review* 597; GW Schwert, 'Markup Pricing in Mergers and Acquisitions' (1996) 41 *Journal of Financial Economics* 153; A Gregory, 'An Examination of the Long Run Performance of UK Acquiring Firms' (1997) 24 *Journal of Business Finance and Accounting* 971; J Harford, M Humphery-Jenner, and R Powell, 'The Sources of Value Destruction in Acquisitions by Entrenched Managers' (2012) 106 *Journal of Financial Economics* 247.

<sup>36</sup> Martynova and Renneboog, 'A Century of Corporate Takeovers' (n 34) 2164; M Martynova and L Renneboog, 'The Performance of the European Market for Corporate Control: Evidence from the Fifth Takeover Wave' (2011) 17 *European Financial Management* 208; BE Eckbo, 'Corporate Takeovers and Economic Efficiency' (2014) 6 *Annual Review of Financial Economics* 51, 67.

<sup>37</sup> A Koulouridas *The Law and Economics of Takeovers: An Acquirer's Perspective* (Hart Publishing 2008) 5; Barger and others (n 32).

<sup>38</sup> Barger and others (n 32). cf D Du and M Gerety, 'Do Private Acquirers Pay Less Compared to Public Acquirers?' (2018) 164 *Economics Letters* 35.

misjudgement.<sup>39</sup> It has been suggested, for example, (1) that bidders overpay because they genuinely overestimate their ability to generate profits from acquisitions and (2) that bidder returns are adversely affected by financing choices, particularly due to high leverage.<sup>40</sup> Another explanation is that bidders overspend on acquisitions due to regulatory intervention in the market for corporate control.<sup>41</sup>

That regulatory intervention could also account for the imbalance in the allocation of takeover gains rather than resolve it might seem oxymoronic. But, as we shall see in Chapter 4, takeover rules aimed at protecting target shareholders can skew the distribution of takeover gains in their favour at the expense of the shareholders of the bidding company. The challenge for the rule-maker therefore is to ensure that rules aimed at protecting target shareholders' interests do just that and nothing more. Otherwise, if such rules result in the conversion of bidder surplus into seller surplus, potential bidders may be discouraged from making bids. Put another way, rules designed to protect target shareholders during takeover bids might have a double negative economic impact. First, they can affect potential bidders' incentives to make bids, *ex ante*. Second, they can affect the distribution of takeover gains, *ex post*. Thus, there is a trade-off between promoting takeovers and protecting target shareholders.

Irrespective of the theory which one may adopt to explain the trend towards an imbalanced distribution of takeover gains, the law must protect all shareholders involved in any given transaction. The economic rationale for such protection in relation to the cost of capital as explained above applies to all shareholders regardless of the side of the transaction on which they may fall. Shareholder protection is necessary to encourage investment in the stock market.

### **3.4.2 Controlling vs Non-Controlling Shareholders**

In companies with a controlling shareholder, agency problems arise between the controlling shareholder and non-controlling shareholders.<sup>42</sup> Although shareholder distributions are probably evolving around the world, public companies in countries other than the US and the UK (and Ireland)<sup>43</sup> 'typically have a single shareholder or group of shareholders with effective voting control, often but not invariably without corresponding equity holdings.'<sup>44</sup> Concentrated

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<sup>39</sup>See Harford, Humphery-Jenner, and Powell (n 35) (suggesting additional explanations).

<sup>40</sup> Koulouridas (n 37).

<sup>41</sup> *Ibid*.

<sup>42</sup> Davies, Hopt, and Ringe (n 6) 208.

<sup>43</sup> M Faccio and LHP Lang, 'The Ultimate Ownership of Western European Corporations' (2002) 65 *Journal of Financial Economics* 365, 379.

<sup>44</sup> RJ Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2006) 119 *Harvard Law Review* 1641, 1643. See OECD, 'OECD Corporate Governance Factbook 2017' (2017) 12-14 <[www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf](http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf)> accessed 19 March 2018.

shareholder distributions are mostly prevalent in continental Europe where corporate control by dominant shareholders commonly derive from the so-called ‘control enhancing mechanisms’ (CEMs); that is, devices that leverage voting rights above the level of equity investment.<sup>45</sup> CEMs generally overlap with most typical pre-bid defences.<sup>46</sup>

Agency problems in companies with a controlling shareholder are similar to those discussed above. In such companies, the controlling shareholder occupies an analogous position to that of the directors of companies without a controlling shareholder, since the controlling shareholder controls management. The controlling shareholder might even be directly involved in management.

In particular, a controlling shareholder of the target company may seek to perpetuate its control for as long as it remains legally possible to extract private benefits of control to an amount sufficient to compensate for the costs of focused managerial monitoring (for ease of reference, let us term this possibility ‘*controlling shareholder entrenchment*’). This could be so even where a prospective acquirer offers a high premium, depending on the controller’s valuation of the extractable private benefits, both pecuniary and nonpecuniary.<sup>47</sup> An inefficient controller that extracts substantial private benefits particularly might have no incentive whatsoever to part with control. The situation could even be worse if a takeover would only occur with the consent of the incumbent controller, specifically where control derives from a CEM or a majority of voting shares. To entice the controller to part with control in this situation, the offered premium must generally exceed not only the extractable pecuniary benefits of control but nonpecuniary benefits as well.<sup>48</sup>

It is no wonder therefore that concentrated shareholder distributions are a significant barrier to takeovers. This is the main explanation why takeovers, especially hostile ones, are rare in continental Europe and in most parts of the world, other than the US and the UK where shareholder distributions are *generally* dispersed.<sup>49</sup> However, this is not to say that all concentrated shareholder distributions are inefficient. Controlling shareholders can be efficient monitors of management in jurisdictions where the law provides sufficient protection for non-

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<sup>45</sup> See Sherman & Sterling LLP, Institutional Shareholder Services, and European Corporate Governance Institute, ‘Report on the Proportionality Principle in the European Union’ (2007) <[http://ec.europa.eu/internal\\_market/company/docs/shareholders/study/final\\_report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf) > accessed 23 February 2018 (detailing various CEMs that are prevalent in the Europe).

<sup>46</sup> M Ventrizzo, ‘Takeover Regulation as a Wolf in Sheep’s Clothing: Taking U.K. Rules to Continental Europe’ (2008) 11 University of Pennsylvania Journal of Business Law 135, 165.

<sup>47</sup> Gilson (n 44) 1665.

<sup>48</sup> Ibid, 1672.

<sup>49</sup> Davies, Hopt, and Ringe (n 6) 206; OECD (n 44) 14.

controlling shareholders against *exploitative* extraction of private benefits over and above those required to compensate for the costs of managerial monitoring.<sup>50</sup>

On the other hand, if the controlling shareholder decides to sell its shares, it might seek to appropriate most of the gains to itself at the expense of non-controlling shareholders (for ease of reference, let us term this possibility ‘*controlling shareholder nest-feathering*’). This could be the case where the bidder acquires control through a negotiated purchase from the controlling shareholder before launching a bid to buy out minority shares. The controlling shareholder might even go so far as to impound in its control premium the bidder’s expected future extraction of private benefits of control, particularly if the acquisition is pursued in order to make the target company a member of a group of companies, where the target company’s business opportunities would be allocated to other group members.<sup>51</sup> This could leave minority shareholders with no chance of selling their shares at a ‘reasonable’ price, effectively making them prisoners of the corporation.

In short, takeover regulation must seek to protect minority or non-controlling shareholders from possible exploitation at the hands of majority or controlling shareholders. Such protection is particularly important in the event of a takeover. An entrenchment-seeking controller may use its position to thwart a transaction which would otherwise enhance value for minority shareholders and improve efficiency by shifting control to a more efficient management team. Or the incumbent controller might feather its own nest, selling its stake at a high premium whilst leaving minority shareholders to be exploited at the hands of the new controller. Here again, the same rationale for shareholder protection in relation to the cost of capital applies.

### **3.4.3 The Bidder vs Non-Shareholders**

Irrespective of the shareholder distribution of the target company, takeovers may also give rise to conflicts of interests between the bidder and non-shareholder stakeholders especially employees and, to some extent, creditors.<sup>52</sup> Specifically, the bidder may seek to terminate some or even all the employees of the target company post-takeover or it may seek to unilaterally alter their conditions of service. And the company’s capacity to repay its debts might be negatively affected by the change of control, especially if the transaction is highly leveraged.

The protection of non-shareholder contractual counterparties of the target company from possible bidder opportunism also has an economic rationale. To put it into perspective, we must

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<sup>50</sup> Gilson (n 44).

<sup>51</sup> Davies, Hopt, and Ringe (n 6) 208.

<sup>52</sup> *Ibid*, 209.

recall that it takes combined inputs and efforts from (1) financial investors (shareholders and creditors) and (2) human capital investors (executives and rank-and-file employees) to build a successful firm.<sup>53</sup> The success of the modern corporation is thus dependent on ‘team production’, as no single constituency alone can make a firm.<sup>54</sup>

Although both employees and creditors can somewhat protect themselves by contract, long-term contracts are by definition ‘incomplete’ contracts. The parties to such contracts must necessarily rely to a considerable extent on ‘informal and legally unenforceable understandings’ in their relationships.<sup>55</sup> The risks associated with long-term contracts in the context of takeovers can be particularly serious in relation to employees, although creditors may also be affected especially if the acquisition is highly leveraged. But long-term creditors for the most part can effectively bargain for themselves and include, for example, ‘event risk’ or ‘change of control’ covenants in lending agreements (albeit these could also be used as devices for managerial entrenchment in form of poison debt).<sup>56</sup> Thus, the ‘cost of capital’ argument is somewhat watered down, at least in relation to long-term creditors.

But the same cannot be said of employees. For example, almost every firm encourages employees to believe that ‘if they stay with the firm, perform well, and the firm prospers, they will receive in the future not just the benefits they are entitled to under their explicit employment contracts (when these exist) but also raises, promotions, and some job security.’<sup>57</sup> Such tacit understandings are threatened by takeovers if the acquirer can easily terminate employees and appropriate to itself the fruits of their labour. Thus, takeovers may operate as a disincentive for employees to acquire firm-specific skills and invest their human capital in the firm on a long-term basis, thereby creating a ‘hold-up’ problem.<sup>58</sup> Employee protection in this vein could operate as a panacea against short-termism by encouraging firm-specific investment for the benefit of the economy. But since takeover bids are addressed to shareholders and not to employees, a tricky question arises as to how employees could be protected under *corporate law* to ameliorate the hold-up problem.<sup>59</sup>

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<sup>53</sup> LA Stout, ‘Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem’ (2002) 55 *Stanford Law Review* 845, 847.

<sup>54</sup> MM Blair and LA Stout, ‘A Team Production Theory of Corporate Law’ (1999) 85 *Virginia Law Review* 247; Stout (n 53); Blair and Stout, ‘Specific Investment’ (n 13).

<sup>55</sup> Stout (n 53) 847-48.

<sup>56</sup> WW Bratton, ‘Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process’ (2006) 7 *EBOR* 39, 58-62; Davies, Hopt, and Ringe (n 6) 210, note 31.

<sup>57</sup> Stout (n 53) 847-48.

<sup>58</sup> Blair and Stout, ‘Specific Investment’ (n 13) 730; Marccus Partners and Centre for European Policy Studies (n 11) 33.

<sup>59</sup> Note that corporate takeover law may be complemented in protecting employees by employment law. See Section 4.3.2 *infra*.

The proponents of the ‘team production’ theory of the corporation suggest that the target board of directors should be allowed to act as a ‘mediating-hierarch’, to strike a fair balance between the interests of all stakeholders particularly shareholders and employees.<sup>60</sup> But it seems that this could be achieved only to the extent that employees’ interests can be aligned with those of the target board.<sup>61</sup> Otherwise, the target board would have no incentive to protect the interests of employees when it also has its own interests to protect.

However, whilst acknowledging that management intervention could also exacerbate management–shareholder agency costs, the proponents of the team production theory argue that such intervention is ‘a “second-best” solution that provides offsetting economic benefits by encouraging and protecting specific investment in corporate production.’<sup>62</sup> Indeed, ‘[a] lack of a highly specialized workforce may well yield higher efficiency costs than prevented control shifts resulting from an entrenched management for certain firms or even sectors of the economy.’<sup>63</sup> If anything, takeover defences may increase shareholder wealth ex ante by encouraging firm-specific investment in team production.<sup>64</sup>

### 3.5 Coordination Problems

A decision to tender or not tender shares for sale at the offered bid price is normally made by each shareholder individually rather than through a collective decision binding on all shareholders.<sup>65</sup> But since the success or failure of the bid depends on the number of shares tendered, each shareholder’s decision can play a role in determining the outcome of the bid. These circumstances may give rise to coordination or collective action problems between the target shareholders. Specifically, two types of coordination problems may arise between shareholders facing of a takeover bid ie the *free-rider problem* and the *pressure to tender*.<sup>66</sup>

Just like agency problems, coordination problems can affect both controlled and widely held companies and tend to be accentuated in the latter.<sup>67</sup> Coordination problems can also impede the efficiency of the market for corporate control. Consider each of these in turn.

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<sup>60</sup> See Blair and Stout, ‘A Team Production Theory’ (n 54); Stout (n 53); Blair and Stout, ‘Specific Investment’ (n 13); M Gelter, ‘The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance’ (2009) 50 Harvard International Law Journal 129.

<sup>61</sup> Davies, Hopt, and Ringe (n 6) 209-10.

<sup>62</sup> Blair and Stout, ‘Specific Investment’ (n 13) 737.

<sup>63</sup> P Davies, E-P Schuster, and E van de Whalle de Ghelcke, ‘The Takeover Directive as a Protectionist Tool?’ in Ulf Bernitz and Wolf-Georg Ringe eds), *Company Law and Economic Protectionism: New Challenges to European Integration* (OUP 2010) 124.

<sup>64</sup> Stout (n 53).

<sup>65</sup> Davies, Hopt, and Ringe (n 6) 224.

<sup>66</sup> Marccus Partners and Centre for European Policy Studies (n 11) 275.

<sup>67</sup> Davies, Hopt, and Ringe (n 6) 224.

### 3.5.1 The Free-Rider Problem

The free-rider problem arises when the target shareholders believe that the premium offered by the bidder does not fully reflect the potential synergies which could be generated by the bidder's future control of the target company.<sup>68</sup> The discovery of this problem is credited to Grossman and Hart who first recorded it in reference to a target company with a fully dispersed shareholder distribution, where the bidder does not own a toehold prior to launching a tender offer.<sup>69</sup> In this context, an individual shareholder's tender decision has a negligible impact on the success or failure of the bid. Thus, in deciding whether to tender or not, each shareholder may ignore its impact on the outcome of the bid.

To elaborate the problem, let  $P$  denote the bid price and  $V$  the net present value of the future stream of profits expected to be generated by the bidder's control of the target company or the post-takeover market value of the company's shares. In this scenario, a small shareholder may not tender unless  $P \geq V$ . Put another way, the shareholder may eschew tendering if  $P < V$  in order to 'free ride' on the bidder's post-takeover value improvement. If all shareholders behaved this way, the bid would necessarily fail. This might occur even if the shareholders may not have access to sufficient information to accurately assess the post-bid value of their shares as they can 'reasonably' anticipate that the share value would exceed the bid price, because otherwise the bidder would make a loss.<sup>70</sup>

In effect, the free-rider problem can make both parties to the transaction worse off. The shareholders may lose the opportunity to exit at a premium from an inefficiently managed firm. The bidder stands to encounter a loss in transaction sunk costs from the abortive takeover. Even if some shareholders may tender their shares, the bid might still fail if the minimum condition (for example, the tender of a majority of two-thirds of shares) is not satisfied.<sup>71</sup> In this scenario, an unsuccessful bidder with a toehold would start languishing as a minority shareholder. Therefore, the free-rider problem can operate as a disincentive for potential bidders to launch takeover bids.

Grossman and Hart, however, acknowledge that the free-rider problem may not completely prevent control transactions as suggested above because otherwise takeovers would not occur

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<sup>68</sup> Marccus Partners and Centre for European Policy Studies (n 11) 71.

<sup>69</sup> SJ Grossman and OD Hart, 'Takeover Bids, The Free-Rider Problem, and the Theory of the Corporation' (1980) 11 *The Bell Journal of Economics* 42. See also L Cohen 'Holdouts and Free Riders' (1991) 20 *Journal of Legal Studies* 351.

<sup>70</sup> D Hirshleifer, 'Mergers and Acquisitions: Strategic and Informational Issues' in RA Jarrow, V Maksimovic, and WT Ziemba (eds), *Handbook of Operations Research and Management Science*, Vol 9 (Elsevier Science 1995).

<sup>71</sup> Marccus Partners and Centre for European Policy Studies (n 11) 71.



in practice.<sup>72</sup> But the success of takeover bids does not necessarily entail the absence of free-riders. Some shareholders may successfully free ride and ‘claim a share’ of the bidder’s profit. Such free-riding is facilitated where the target shareholders can easily cooperate and ‘collude’ to tender only a sufficient number of shares to meet the minimum condition of the bid and hold on to some of their shares, to extract greater benefits post-takeover.<sup>73</sup> Thus, even minority free-riders can discourage bidding, especially if the bidder is seeking to acquire full ownership of the target company. However, this problem is less significant in jurisdictions where the bidder can dilute the free-riders’ value post-takeover by extracting substantial private benefits.<sup>74</sup>

### **3.5.2 The Pressure to Tender**

We may recall from the preceding discussion that the pressure to tender is one of the inherent characteristics of a typical tender offer.<sup>75</sup> The pressure to tender is also one of the reasons why the free-rider problem does not normally manifest in its severest form. A shareholder who would otherwise prefer giving free-riding a go ‘might tender out of fear that, if he does not tender, the bidder might still gain control, in which case the shareholder would be left with low-value minority shares in the acquired target [company].’<sup>76</sup> Thus, any shareholder – including a controlling minority shareholder – who may be ‘overtaken’ by the bidder can be subjected to the pressure to tender. But of course, this pressure is likely to be more severe among dispersed minority shareholders who may not be able to bear with coordination costs. If the target company has a controlling shareholder, the bidder may negotiate directly with the controlling shareholder. This would send minority shareholders into panic due to uncertainty as to how the value of their shares would be affected thus forcing them to tender, even at a suboptimal price.<sup>77</sup>

At the heart of the ‘pressure-to-tender problem’ is the shareholders’ inability to coordinate and adopt a collective decision which would be in the best interest of all of them. This results in the ‘prisoners’ dilemma.’<sup>78</sup> as each shareholder must individually bet on the success or failure of the bid in the absence of information as to whether other shareholders would tender or not. The lack of information concerning the success of the bid is exacerbated by the target shareholders’ inability to accurately assess the post-takeover value of their shares, also due to

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<sup>72</sup> Grossman and Hart (n 69) 45.

<sup>73</sup> Marccus Partners and Centre for European Policy Studies (n 11) 72.

<sup>74</sup> Grossman and Hart (n 69).

<sup>75</sup> See Section 3.2 above.

<sup>76</sup> LA Bebchuk, ‘The Pressure to Tender: An Analysis and a Proposed Remedy’ (1987) 12 Delaware Journal of Corporate Law 911, 911.

<sup>77</sup> See Davies, Hopt, and Ringe (n 6) 224.

<sup>78</sup> See Marccus Partners and Centre for European Policy Studies (n 11) 276-78.

asymmetric information. In assessing whether one would be better off tendering or holding out, each shareholder must therefore consider two inverse possibilities: (1) that the bid will fail; and (2) that the bid will succeed.<sup>79</sup>

In short, a combination of the prospects of the bid succeeding and minority shares being illiquid and of lower value than the bid price post-takeover is what engenders the pressure to tender.<sup>80</sup> The post-takeover value of minority shares is likely to be lower than the bid price if the acquirer would be able to extract substantial pecuniary private benefits of control and engage in self-dealing or allocate to itself (or another member of its corporate group) the target company's business opportunities, particularly in jurisdictions where the law restraining such behaviour is not strict.<sup>81</sup> Thus, minority shareholders would not be able to sell their shares at a 'fair' price even if they decided to exit the target company after the takeover. In some jurisdictions, minority shareholders might also be forced to sell their shares post-takeover at a price significantly lower than the bid price through a takeout or freezeout merger between the target company and the bidder.<sup>82</sup> These possibilities can exacerbate the pressure to tender.

We must recall that the pressure to tender can arise in all takeover bids irrespective of whether the bid in question is nonpartial (for all shares), partial (for a portion of shares), or two-tier (based on price discrimination).<sup>83</sup> Of course, the pressure is liable to be more prominent in the face of two-tier bids and partial bids; since the low value of minority shares can be readily anticipated in two-tier bids, and it is obvious in a partial bid that if the bid is successful some shareholders must remain as minorities.<sup>84</sup> This can be contrasted with a one-tier, nonpartial bid in which all those who may decide to tender are assured of selling all their shares in the event of the bid succeeding.<sup>85</sup> But since the pressure to tender is caused by liquidity concerns and the fear that the post-takeover value of minority shares would be lower than the bid price, the

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<sup>79</sup> Bebchuk, 'The Pressure to Tender' (n 76) 923.

<sup>80</sup> Bebchuk, 'The Pressure to Tender' (n 76) 923; Marccus Partners and Centre for European Policy Studies (n 11) 73. See M Bradley, 'Interfirm Tender Offers and the Market for Corporate Control' (1980) 53 *The Journal of Business* 345, 352-56.

<sup>81</sup> Bebchuk, 'The Pressure to Tender' (n 76) 918-19. For comparative regulatory approaches to self-dealing and appropriation of corporate business opportunities, see Z Goshen, 'The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality' (2003) 91 *California Law Review* 393; P-H Conac, L Enriques and M Gelter 'Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy' (2007) 4 *ECFR* 491; MC Corradi, 'Corporate Opportunities Doctrines Tested in the Light of the Theory of the Firm – a European (and US) Comparative Perspective' (2016) 27 *European Business Law Review* 755.

<sup>82</sup> Bebchuk, 'The Pressure to Tender' (n 76) 917-22. EU law provides for a 'post-takeover squeeze-out right' exercisable at a 'fair price' but some European jurisdictions, eg the UK and Germany, also make provision for 'general squeeze-outs'. See M Ventoruzzo 'Freeze-Outs: Transcontinental Analysis and Reform Proposals' (2010) 50 *Virginia Journal of International Law* 841, 900-02.

<sup>83</sup> Bebchuk, 'The Pressure to Tender' (n 76) 925-27.

<sup>84</sup> *Ibid*, 926.

<sup>85</sup> *Ibid*.

pressure can arise irrespective of however the bid may be structured.

The effect of the pressure to tender is that it distorts the affected shareholders' tender choice. Specifically, shareholders who would otherwise prefer holding out are coerced into tendering. This may lead to inefficiency even if the bid price is well above the prevailing market share price. Empirical evidence from the past has shown that the rejection of a premium bid could, in some cases, turn out to be value-maximising for the target shareholders.<sup>86</sup>

Therefore, takeover regulation must seek to ensure that shareholder choice is not distorted by the pressure to tender. Undistorted choice could ensure that the target company is acquired only if the majority of its shareholders view the bid price as being higher than the company's pre-takeover value.<sup>87</sup> This could not only maximise shareholder value. It could also produce social (efficiency) gains by ensuring that control shifts to a management team that values the target assets above the value which the incumbent management can generate.<sup>88</sup>

But this is not to say that ensuring undistorted choice can always lead to efficiency. As we have noted above, the target shareholders may not be able to accurately assess the value of their company due to asymmetric information, and the bidder may not be willing to meet the full pre-takeover value of the target company due to some strategic considerations and transaction costs.<sup>89</sup> However, these two concerns can arise even in the absence of collective action problems, where a sole proprietor decides to sell his property at a price he believes to be higher than the value to himself of retaining it.<sup>90</sup> Thus, the undistorted choice mechanism seems to be the best way of addressing the possible inefficiencies of the pressure to tender.

### **3.6 Conclusion**

In pursuit of the first objective of our study, this chapter has highlighted the mechanics of corporate takeovers and takeover bids. The discussion has brought to light two multifaceted economic issues which takeover rules should respond to, to address possible market failures in the market for corporate control ie agency problems and coordination problems. Failure to address these problems can impede the efficiency of the market for corporate control, leading to a chilling effect on the exercise of the freedom of establishment through corporate takeovers.

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<sup>86</sup> M Bradley, A Desai and EH Kim, 'The Rationale Behind Interfirm Tender Offers: Information or Synergy?' (1983) 11 *Journal of Financial Economics* 183, 188. See also Bebchuk, 'The Pressure to Tender' (n 76) 929-30 (giving several examples of circumstances when the rejection of a premium could be value-maximising).

<sup>87</sup> Bebchuk, 'The Pressure to Tender' (n 76) 914-17.

<sup>88</sup> *Ibid*, 915.

<sup>89</sup> LA Bebchuk, 'Toward an Undistorted Choice and Equal Treatment in Corporate Takeovers' (1985) 98 *Harvard Law Review* 1695, 1770-74.

<sup>90</sup> Bebchuk, 'The Pressure to Tender' (n 76) 915.

## 4 The EU's Regulatory Response

### 4.1 Introduction

In the EU, takeover bids are regulated within the framework of the Takeover Bids Directive of 21 April 2004<sup>1</sup> as slightly amended in 2009<sup>2</sup> and 2014<sup>3</sup> respectively. To attain an efficient European market for corporate control and to foster the freedom of establishment of companies through takeovers, it is this piece of legislation which ought to address the agency and coordination problems which we have identified in Chapter 3. This chapter examines how the Takeover Bids Directive responds to those problems and how such response could affect potential bidders' incentives and/or ability to conduct takeovers. The chapter begins by providing an overview of the Directive in Section 4.2. Sections 4.3 to 4.7 then examine the key provisions of the Directive which are designed to respond to the problems under discussion. And Section 4.8 concludes.

### 4.2 An Overview of the Takeover Bids Directive

The Takeover Bids Directive sets out *minimum guidelines*<sup>4</sup> for the conduct of takeover bids relating to the securities of companies governed by the laws of Member States, where all or some of those securities are admitted to trading on a regulated market.<sup>5</sup> Article 2 of the Directive defines the term 'securities' as 'transferable securities carrying voting rights in a company.' In other words, the term securities as used in the Directive does not capture non-voting shares.

Article 3 sets out six general principles which Member States must comply with when implementing the provisions of the Directive. These are: (1) all holders of securities of the target company of the same class must be treated equally; (2) the holders of securities of the target company must be given sufficient time and information to reach a properly informed decision on the bid; (3) the board of the target company must act in the interests of the company as a whole; (4) any conduct which could make the securities at stake rise or fall artificially in price

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<sup>1</sup> Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids [2004] OJ L142/12 (Takeover Bids Directive).

<sup>2</sup> Regulation (EC) No 219/2009 of the European Parliament and of the Council of 11 March 2009 adapting a number of instruments subject to the procedure referred to in Article 251 of the Treaty to Council Decision 1999/468/EC with regard to the regulatory procedure with scrutiny - Adaptation to the regulatory procedure with scrutiny — Part Two [2009] OJ L87/109, art 5.

<sup>3</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council [2014] OJ L173/190, art 119.

<sup>4</sup> This means that Member States may adopt stricter national rules to regulate the conduct of takeover bids. See Takeover Bids Directive (n 1), recital 26 and art 13.

<sup>5</sup> Takeover Bids Directive (n 1), recital 25 and art 1.

must be prevented and prohibited; (5) the bidder must not announce the bid unless it has sufficient resources to finance it; and (6) the target company must not be hindered in its business activities for longer than is reasonable. Provided that these general principles are respected, Article 4(5) permits Member States to derogate from the provisions of the Directive.

Article 4 of the Directive requires Member States to designate an authority or authorities to supervise the conduct of takeover bids. According to this provision, it is incumbent upon Member States to decide which judicial or other authority would handle any disputes or irregularities in a bid. But if the securities of the target company are listed in more than one Member State, the target company must determine which national supervisory authority should supervise the bid.

The substantive provisions designed to address the agency and coordination problems identified in Chapter 3 are set out from Article 5 through Article 16 of the Directive. Specifically, these Articles make provision for (1) disclosure of certain information, (2) mandatory bids, (3) board neutrality in the face of a bid, (4) a possibility to ‘break-through’ certain takeover barriers, and (5) post-bid freezeout or squeeze-out and sell-out rights.

However, the Directive does not contain specific provisions aimed at addressing agency problems which may arise between the constituencies of the bidding company. Apart from disclosure requirements which could be beneficial to all stakeholders, the Directive focuses on regulatory problems which tend to affect the target company. A possible explanation for this is that agency problems which may affect the bidding company are not peculiar to takeovers. Acquisition decisions form part of corporate strategy and any conflicts of interests arising in this connection are addressed by general corporate governance law.<sup>6</sup> For the reason given in Section 3.4.3, the Directive does not provide special protection for creditors either.

### **4.3 Disclosure Requirements**

The Takeover Bids Directive makes provision for two main forms of disclosures, namely *pre-bid* general disclosures and *bid-related* disclosures.<sup>7</sup> The Directive also leaves it open for Member States to require additional country-specific disclosures.<sup>8</sup>

#### *(a) Pre-bid disclosures*

Pre-bid general disclosure requirements are provided for in Article 10 of the Directive. The

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<sup>6</sup> P Davies, K Hopt, and W-G Ringe, ‘Control Transactions’ in R Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 208.

<sup>7</sup> Marcus Partners and Centre for European Policy Studies, ‘The Takeover Bids Directive Assessment Report’ (June 2012) 245 <[http://ec.europa.eu/internal\\_market/company/docs/takeoverbids/study/study\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/takeoverbids/study/study_en.pdf)> accessed 2 March 2018.

<sup>8</sup> *Ibid.* See Takeover Bids Directive (n 1), art 3(2) and 13.

disclosure of toeholds and equity derivatives under the Transparency Directive<sup>9</sup> also falls under this taxonomy. These disclosure requirements apply to all publicly traded companies, whether they are involved in the market for corporate control or not. Article 10 of the Takeover Bids Directive requires disclosure of a wide range of information – listed from Article 10(1) (a) through Article 10(1) (k) – pertaining to ownership and control structures. It encompasses some common CEMs which could also operate as pre-bid defences, including those that may be triggered ‘automatically’ by a change of control such as golden parachutes, poison pills, poison debt, etc. All such information must be disclosed in the company’s annual report as provided for by the Directive on Annual Financial Statements,<sup>10</sup> and the board must present a report to the annual general meeting of shareholders explaining why such ownership and control structures exist.<sup>11</sup>

*(b) Bid-related disclosures*

Bid-related disclosure requirements are provided for in Articles 6, 8, and 9(5) of the Directive. Article 6 requires a *timely* disclosure of the bid to the public. Upon such disclosure and without delay, the boards of both the target company and the bidder must inform the representatives of their respective employees – or, absent such representatives, the employees themselves – about the bid. Article 6 further requires the bidder to draw up and make public in good time an offer document detailing necessary information to enable the target shareholders to reach a properly informed decision on the bid. The provision particularises a range of *minimum details* which the offer document must contain, including information relating to the bidder’s post-takeover business plans which could affect employees.

To prevent the publication and dissemination of false or misleading information, Article 8 underscores the need to make the bid public in a manner that ensures market transparency and integrity for the securities of the target company, of the bidder and of any other company which may be affected by the bid. This provision also requires Member States to ensure that all information and documents required by Article 6 regarding the terms of the bid are made promptly and readily available to the target shareholders and to the representatives of

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<sup>9</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38 which was last amended by Directive 2013/50/EU (Transparency Directive), arts 9 and 13.

<sup>10</sup> Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC [2013] OJ L182/19.

<sup>11</sup> Takeover Bids Directive (n 1), art 10(2) and (3).

employees of both the target company and the bidder or, absent such representatives, to the employees themselves.

The target board is mandated by Article 9(5) of the Directive to draw up and make public a document setting out its opinion of the bid, including its views on the effects of the proposed takeover on all the target company's interests and, specifically, on employment. The opinion must be communicated to the representatives of employees or, absent such representatives, to the employees themselves. Moreover, Article 14 clarifies that none of the disclosures required by the Directive detracts from any applicable national rules pertaining to information and consultation rights of the representatives of employees or rules pertaining to co-determination.

#### **4.3.1 The Rationale for Disclosure Requirements**

We may recall from Chapter 3 that agency problems and coordination problems are both exacerbated by information asymmetries or the so-called 'lemons problem'.<sup>12</sup> Disclosure of up-to-date, accurate, and relevant information can ameliorate both problems.<sup>13</sup>

The requirements to disclosure and justify the existences of CEMs, pre-bid defences and potential post-bid defences provided for in Article 10 of the Directive can deter both managerial entrenchment and controlling shareholder entrenchment. These requirements render it difficult for incumbents to implement some pre-bid defensive tactics devoid of any commercial rationale. Once disclosed to the public, such tactics can also make the company less attractive to potential investors.<sup>14</sup> Thus, pre-bid disclosures can deter the adoption of pre-bid defences especially by companies seeking to raise capital from the public. The obligation to disclosure share purchases and equity derivatives under the Transparency Directive also mitigates the risk of controlling shareholder nest-feathering through surreptitious sales and acquisitions.

By keeping potential target shareholders informed about how insulated or susceptible the company is to takeovers and what defences the incumbent controllers may use to defeat a takeover attempt, pre-bid disclosures might offer an opportunity for minority shareholders to challenge undesirable decisions by the incumbents. Potential bidders could also use the disclosed information to identify their competitors and to assess how attractive a potential target is, and plan beforehand how to circumvent any barriers or indeed avoid the target altogether.<sup>15</sup>

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<sup>12</sup> See PM Healy and KG Palepu, 'Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature' (2001) 31 *Journal of Accounting and Economics* 405, 407-10.

<sup>13</sup> Davies, Hopt, and Ringe (n 6) 224.

<sup>14</sup> See T Papadopoulos, 'The European Union Directive on Takeover Bids: Directive 2004/25/EC' (2008) 6 *International and Comparative Corporate Law Journal* 13, 60 (arguing that disclosure of information concerning defensive structures such as pyramids and cross-shareholdings might affect the credit ranking of companies).

<sup>15</sup> See Marccus Partners and Centre for European Policy Studies (n 7) 45.

This may save potential bidders some transaction costs in the event of insurmountable barriers.

Bid-related disclosures may similarly be beneficial to shareholders of both the bidder and the target company. These disclosures may reduce the risk of free-riding and the pressure to tender particularly if the disclosed information is so sufficient and credible as to enable the shareholders to make an informed decision on the bid.<sup>16</sup> Bid-related disclosures are reinforced by Article 9(5) of the Directive which mandates the target board to disclose its opinion on the bid and Article 7 which prescribes the time allowed to accept a bid, to ensure that shareholders have sufficient time to assimilate the disclosed information. Article 7 provides that the acceptance period may not be less than two weeks nor more than ten weeks from the date of publication of the offer document. But Member States may allow the bidder to extend the acceptance period beyond ten weeks upon giving two weeks' notice, provided that such extension does not hinder the business activities of the target company for longer than is reasonable. This could significantly reduce the pressure to tender. The transparency resulting from various disclosures could also help forestall opportunistic behaviour, including against employees, as the likelihood of such behaviour occurring is exposed beforehand.

#### **4.3.2 Deficiencies and Drawbacks**

Disclosure requirements perhaps constitute the most important aspects of efficient takeover regulation because the effectiveness of all other takeover rules is largely dependent on timely and accurate disclosure of all relevant information. But these requirements have some deficiencies and drawbacks.

As concerns pre-bid disclosures, the information disclosed in annual financial statements may not be up-to-date as and when such information is needed. Although some information – such as beneficial ownership of voting rights – must be disclosed on an ongoing basis, the directors of both the target company and the bidder are likely to be better informed about their respective companies than other stakeholders.<sup>17</sup> The rapid disclosure of beneficial ownership of voting rights also exacerbates the risk of managerial and controlling shareholder entrenchment by increasing the time available to prepare defensive measures.<sup>18</sup> This also means that potential bidders cannot meaningfully exploit the strategic advantages of commencing the takeover process with a toehold,<sup>19</sup> although the efficiency of toeholds is debatable.<sup>20</sup>

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<sup>16</sup> See Marccus Partners and Centre for European Policy Studies (n 7) 278.

<sup>17</sup> Davies, Hopt, and Ringe (n 6) 225.

<sup>18</sup> *Ibid*, 222.

<sup>19</sup> See M Lipton, 'Open Market Purchases' (1977) 32 *The Business Lawyer* 1321, 1321 (explaining several strategic reasons why prospective bidders often purchase shares in the target company before launching a bid).

<sup>20</sup> See Marccus Partners and Centre for European Policy Studies (n 7) 293.



Consequently, pre-bid disclosures might have a chilling effect on the exercise of the freedom of establishment through the market for corporate control.

Bid-related disclosures are likely to be more informative and more up-to-date than pre-bid disclosures. But the problem of asymmetric information and attendant agency costs may not be fully resolved because individuals process information differently.<sup>21</sup> In any case, bombarding unsophisticated investors with excessive information can undermine their ability to understand complex information, to make rational choices.<sup>22</sup> Minority shareholders are therefore likely to place heavy reliance on the board's opinion. But since the target board is normally conflicted, its opinion may be biased unless the board is dominated by 'truly' independent directors or the opinion is based on an independent expert report. Thus, the failure by the Directive to make an express provision to ensure that the board's opinion is devoid of self-serving biases seems to be a loophole, furthering agency problems.

Article 7 of the Directive which requires Member States to ensure that the bid remains open for acceptance for a period of two to ten weeks, with a possibility to grant an extension, can also offer an opportunity for the board to adopt defensive measures.<sup>23</sup> The emergence of a white knight or other competing bidders is likely to be facilitated too. Whilst this may be desired from the perspective to the target shareholders, the initial bidder may lose the bidding contest and suffer a loss in transaction costs. This possibility could operate as a disincentive for potential bidders to launch bids.<sup>24</sup>

A related concern arising from disclosure requirements is that the cost of fulfilling these requirements may discourage bidding. However, it is argued that disclosure costs are less significant relative to the total costs incurred by bidders and therefore may not significantly affect bidders' incentives, perhaps except for small and financially constrained SMEs.<sup>25</sup>

Further, as concerns the protection of employees, disclosure requirements sit in a vacuum since only shareholders can determine the fate of the bid<sup>26</sup> unless, of course, the target board can adopt defensive measures. But as we shall see in Section 4.5 below, the Takeover Bids Directive seeks to preclude the target board from adopting takeover defences without the approval of shareholders. This means that in cases where this preclusion applies, bid-related disclosures cannot in themselves resolve the potential conflicts, which create the hold-up

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<sup>21</sup> Marccus Partners and Centre for European Policy Studies (n 7) 278.

<sup>22</sup> *Ibid*, 297.

<sup>23</sup> Davies, Hopt, and Ringe (n 6) 225.

<sup>24</sup> *Ibid*.

<sup>25</sup> Marccus Partners and Centre for European Policy Studies (n 7) 247.

<sup>26</sup> Davies, Hopt, and Ringe (n 6) 209.

problem, between the bidder and the target employees. Thus, the representatives of employees in Europe have expressed dissatisfaction with the lack of safeguards in the Directive against the risks of change in working conditions and redundancies post-takeover.<sup>27</sup>

However, the need for more tangible safeguards for employees under takeover regulation should not be exaggerated. The existing disclosure requirements are rendered effective by employment law within the framework of Directive 2001/23/EC<sup>28</sup> and Directive 2002/14/EC.<sup>29</sup> In any event, as noted above, Article 14 of the Takeover Bids Directive preserves the employees' rights to consultation and co-determination as may be provided for under national law. Thus, there seems to be no serious cause for concern apart from – as the European Parliament has observed – the need to ensure effective enforcement mechanisms of both disclosure requirements under the Takeover Bids Directive and the relevant provisions of the directives on employment law.<sup>30</sup> Perhaps, the scope of information to be disclosed could also be somewhat broadened as suggested by the results of a study conducted in 2011.<sup>31</sup>

#### **4.4 The Mandatory Bid Rule**

The mandatory bid rule (MBR) is contained in Article 5 of the Directive. The rule has two main elements, namely 'mandatory bid' and 'equitable price'. As concerns the first element, Article 5(1) provides that where a person – acting alone or in concert with others – acquires a specified percentage of voting rights in a listed company giving that person control of the company, such a person must at the *earliest opportunity* launch a bid addressed to *all* minority shareholders of the company for *all their holdings*. The Directive does not define 'control'. Nor does it provide a fixed threshold representing a presumption of control. Instead, Article 5(3) confers discretion on Member States to set their own presumptive control thresholds under national law.<sup>32</sup>

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<sup>27</sup> 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' COM (2012) 347 final (Commission's 2012 Report), para 10.

<sup>28</sup> Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses [2001] OJ L82/16.

<sup>29</sup> Directive 2002/14/EC of the European Parliament and of the Council of 11 March 2002 establishing a general framework for informing and consulting employees in the European Community [2002] OJ L80/29.

<sup>30</sup> European Parliament Resolution of 21 May 2013 on the application of Directive 2004/25/EC on takeovers bids (2012/2262(INI)) [2016] C55/01, paras 17-19. See also M Ventoruzzo, 'Europe's Thirteenth Directive and U.S. Takeover Regulation: Regulatory Means and Political Economic Ends' (2006) 41 *Tex Int'l LJ* 171, 178 (arguing that the interests of employees and other stakeholders who might be affected by takeovers 'are not necessarily what should be protected through takeover regulation, but they are sufficiently important to be accounted for in any regulatory regime').

<sup>31</sup> Marccus Partners and Centre for European Policy Studies (n 7) 254-57.

<sup>32</sup> This is probably a sound approach as a single threshold can have very different implications in different Member States, depending on the predominant ownership structures.

There are two exceptions to the mandatory bid requirement. By Article 5(2), the requirement does not apply where control has been acquired following a voluntary bid addressed to *all the holders of securities for all their holdings* in the acquired company. The mandatory bid requirement does not apply in the case of use of resolution tools, powers and mechanisms provided for in Title IV of Directive 2014/59/EU either.<sup>33</sup>

As concerns the second element, Article 5(1) requires the acquirer to offer an equitable price for the securities to which the mandatory bid applies. An ‘equitable price’ is defined in Article 5(4) as the highest price paid for the same securities by the acquirer, or by persons acting in concert with the acquirer, over a period – as determined by each Member State – of not less than six months but not more than twelve months prior to the mandatory bid or any higher price paid for the same securities before the lapse of the mandatory bid.

Article 5(5) makes provision for the form which the consideration must take to be presumed equitable as such. It provides that the consideration may take the form of securities, cash or a combination of both. However, if the consideration offered does not consist of liquid securities admitted to trading on a regulated market, cash must be offered as an alternative. In any event, a cash consideration must be offered at least as an alternative where the acquirer or persons acting in concert with the acquirer, over a period referred to in the preceding paragraph has purchased for cash securities carrying 5% or more of the voting rights in the acquired company. Member States are also permitted to require in all cases that a cash consideration be offered as an alternative.

Article 5(4) also provides for a possibility in certain circumstances for national supervisory authorities in accordance with national law to adjust the mandatory bid price, either upwards or downwards, according to clearly determined criteria. Any decision to adjust the equitable price as such must be substantiated and made public.

#### **4.4.1 The Rationale for Mandatory Bids**

According to Article 5(1) of the Directive, a mandatory bid is required as a means of protecting minority shareholders of the target company when control changes hands. Consistent with our framework of market failures, it is argued that the MBR has two economic rationales in this connection.<sup>34</sup> The first is to protect minority shareholders from opportunistic behaviour (ie controlling – non-controlling shareholder agency conflicts) by affording them an early opportunity to exit an acquired company at a fair price, thereby also preventing value-

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<sup>33</sup> Takeover Bids Directive (n 1) as amended by Directive 2014/59/EU (n 3), art 119.

<sup>34</sup> Marccus Partners and Centre for European Policy Studies (n 7) 289.

decreasing transactions and reducing the cost of capital.<sup>35</sup> In other words, a mandatory bid is deemed necessary to prevent a new controller from extracting private benefits at the expense of minority shareholders.<sup>36</sup> Value-decreasing transactions could be prevented as prospective acquirers are likely to acquire control in the presence of the MBR only if their valuation of the target company is higher than the market valuation, because otherwise they would make a loss.

The second rationale for the MBR is to reduce the pressure to tender.<sup>37</sup> Specifically, in the event of a partial bid, minority shareholders may not be panicked into tendering if they know that a mandatory bid, at an equitable price, for *all* their shares would soon follow. This could also contribute to the prevention of value-decreasing transactions. Article 5(2) which exempts from the mandatory bid requirement acquirers who acquire control through a nonpartial bid operates as an incentive for bidders to make one-tier bids for all shares and spare themselves the cost of making two separate bids. We must recall, however, that the MBR applies irrespective of whether control has been acquired through a partial bid, a negotiated block purchase, an open market purchase, or a combination of these. This means that the MBR has no effect on the pressure to tender in cases where the obligation to launch a bid is triggered by a non-bid acquisition.<sup>38</sup>

#### 4.4.2 Deficiencies and Drawbacks

At first blush, the MBR appears attractive insofar as the protection of minority shareholders is concerned. But there are several fundamental issues which may detract from the efficiency and effectiveness of this rule. To begin with, we must recall that the MBR neither prohibits partial bids nor renders it impossible to launch one.<sup>39</sup> The threshold triggering mandatory bids in most Member States is either set at 30% or 33% of voting rights albeit a handful of Member States have adopted a 50% threshold.<sup>40</sup> This means that it is possible to make a partial bid and acquire working (de facto) control, especially of a widely held company, below these thresholds without triggering the mandatory bid requirement.<sup>41</sup>

However, the MBR may not be circumvented if the target company has an incumbent

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<sup>35</sup> Ibid.

<sup>36</sup> M Goergen, M Martynova and L Renneboog. 'Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe' (2005) 21 Oxford Review of Economic Policy 243, 250.

<sup>37</sup> Marccus Partners and Centre for European Policy Studies (n 7) 289.

<sup>38</sup> M Burkart and F Panunzi, 'Mandatory Bids, Squeeze-Outs, Sell-Out and the Dynamics of the Tender Offer Process' (2003) ECGI Law Working Paper No 10/2003, 21.

<sup>39</sup> L Enriques, 'The Mandatory Bid Rule in the Takeover Directive: Harmonization without Foundation' (2004) 1 ECFR 440, 446. The definition of the term 'takeover bid' given in art 2(1)(a) of the Takeover Bids Directive also encompasses partial bids.

<sup>40</sup> Marccus Partners and Centre for European Policy Studies (n 7) 291.

<sup>41</sup> Enriques (n 39) 446.

controller that enjoys de facto control deriving from 29.9% or 32.9% of voting rights where the triggering threshold is 30% or 33% of voting rights respectively.<sup>42</sup> In this scenario, an interested acquirer must either negotiate to purchase the stake of the incumbent or otherwise launch a bid for all the shares of the target company, since any acquisition of voting rights above those held by the incumbent would invariably trigger the requirement to launch a mandatory bid. The incumbent would therefore be able to ask for a control premium up to the total value of minorities shares,<sup>43</sup> in which case the prospective acquirer would be better off launching a bid for all shares to acquire de jure control instead of mere de facto control. But the bid might fail in the absence of the controlling shareholder tendering its shares.

In effect, the MBR increases the bargaining power of incumbent controllers and makes takeovers more expensive for potential bidders seeking to acquire more than 50% of voting rights, as is normally the case, or indeed de facto control above the applicable mandatory bid threshold. The rule significantly limits the possibility to make a partial bid especially for companies with a controlling shareholder. The contestability of control for such companies is virtually eliminated by the MBR in that control may never shift without the consent of the incumbent. In short, the MBR has a chilling effect on the market for corporate control and the freedom of establishment especially in continental Europe where most listed companies have a controlling shareholder.

But does the MBR offer sufficient protection for minority shareholders from the extraction of private benefits and/or the pressure to tender to justify its existence? We have already seen that the MBR has no effect in a dispersed ownership environment unless the bidder seeks to acquire a percentage of voting rights that exceeds the applicable mandatory bid triggering threshold. It has also been acknowledged by the Commission that the concept of ‘acting in concert’ which Article 5 introduces might be a source of legal uncertainty among investors and that, among other things, it could discourage shareholder activism, as cooperating investors may fear that they may be compelled to make a takeover bid.<sup>44</sup> Importantly, this concept offers an opportunity for circumvention of the MBR. For example, depending on the definition which a Member State has adopted, control may be acquired – without triggering a mandatory bid – through a purchase of shares on secondary markets or through cooperation between shareholders to exercise ‘joint control’.<sup>45</sup> Further, the Directive confers discretion on Member

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<sup>42</sup> Marccus Partners and Centre for European Policy Studies (n 7) 292.

<sup>43</sup> Ibid.

<sup>44</sup> Commission’s 2012 Report (n 27), para 23. The amendment by Directive 2014/59/EU (n 3), art 119 was an attempt to mitigate this effect.

<sup>45</sup> Marccus Partners and Centre for European Policy Studies (n 7) 289.

States to allow their national supervisory authorities to grant exemptions from the MBR and to adjust the mandatory bid price on a case-by-case basis.<sup>46</sup> Consequently, Member States have adopted ‘a wide variety of national derogations’ from the MBR.<sup>47</sup> This too could undermine the very purpose of the rule.

Moving away from the loopholes, the MBR itself has very limited capacity to resolve the economic problems which it purports to address. Bergström, Högfeldt and Molin demonstrate empirically that, in a fully dispersed ownership environment, the implementation of the MBR does not generally benefit minority shareholders.<sup>48</sup> They show that the rule is in fact liable to harm minority shareholders. Specifically, minority shareholders are liable to encounter a loss from the implementation of the MBR unless the difference in pecuniary private benefits between the incumbent controller and the prospective acquirer is large.<sup>49</sup>

To elaborate, let  $I$  denote the incumbent;  $R$  the prospective acquirer;  $Y^I$  and  $Y^R$  their respective security benefits; and  $Z^I$  and  $Z^R$  their respective pecuniary private benefits. In this scenario, if  $Y^I > Y^R$  and  $Z^I < Z^R$  minority shareholders would be worse off if the transaction went through. The MBR would be in the minority shareholders’ interest here if it prevented such a transaction from occurring, because otherwise minority shareholders would be left with the lower security benefits of the acquirer.<sup>50</sup> Conversely, if  $Y^I < Y^R$  and  $Z^I > Z^R$  minority shareholders would be better off if the transaction went through. In this scenario, a partial acquisition would be beneficial to the minority shareholders since the value of their shares would increase post-acquisition.<sup>51</sup>

In short, the effect of the MBR on shareholder wealth is ‘uniformly nonpositive’ if the private benefits of the contestants for control are of about equal size.<sup>52</sup> This holds true whether the incumbent controller is a management team or a blockholder. The MBR benefits shareholders if, and *only if*, the difference between the bidder and the incumbent in private benefits is large *relative* to the difference in security benefits<sup>53</sup> or, in other words, if competition by the incumbent forces the bidder to offer *at least* the pre-takeover share value.<sup>54</sup>

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<sup>46</sup> Takeover Bids Directive (n 1) arts 4(5) and 5(4).

<sup>47</sup> Commission’s 2012 Report (n 27), para 24 (see also para 25).

<sup>48</sup> C Bergström, P Högfeldt and J Molin ‘The Optimality of the Mandatory Bid Rule’ (1997) 13 *Journal of Law, Economics, & Organization* 433.

<sup>49</sup> *Ibid*, 435.

<sup>50</sup> *Ibid*, 436. See C Van der Elst and L Van den Steen, ‘Opportunities in the Merger and Acquisition Aftermarket: Squeezing Out and Selling Out’ in GN Gregoriou and L Renneboog (eds), *Corporate governance and Regulatory Impact on Mergers and Acquisitions* (Elsevier 2007) 200.

<sup>51</sup> Bergström, Högfeldt and Molin (n 48) 436; Van der Elst and Van den Steen (n 50) 200-01.

<sup>52</sup> Bergström, Högfeldt and Molin (n 48) 435.

<sup>53</sup> *Ibid*, 447.

<sup>54</sup> Burkart and Panunzi, (n 38) 15.

We must recall that the amount of extractable private benefits is always limited by the applicable law and the rigour of available enforcement mechanisms.<sup>55</sup> Since controllers generally have an incentive to extract private benefits to the highest possible legal limit, it is unlikely that in any given jurisdiction a partial acquirer would extract substantially higher benefits than the incumbent.<sup>56</sup>

The MBR is therefore barely justifiable. To the extent that it discourages value-maximising partial control transactions, the rule is both allocatively and distributively inefficient.<sup>57</sup> It is allocatively inefficient because it retains control in the hands of inefficient controllers. And it is distributively inefficient because it deprives minority shareholders of higher surplus by preventing value-maximising control shifts.

Even the argument that the MBR ameliorates the pressure to tender by discouraging partial bids barely justifies the rule. As we may recall from Section 3.5.2, the pressure to tender arises whether the bid in question is partial or otherwise. Of course, as we have already acknowledged, a nonpartial bid engenders less pressure to tender than a partial or two-tier bid. However, the pressure to tender cannot be eliminated by requiring a nonpartial bid. Thus, even if the MBR were necessary to reduce the pressure to tender it would still have to be supplemented by another provision to achieve the desired result ie undistorted tender choice. In view of the potential negative allocative and distributive effects stated above, mere partial reduction in the pressure to tender may not sufficiently offset the cost of lost opportunities for efficient control shifts resulting from the implementation of the MBR.

All in all, the MBR can have a significant chilling effect on the European market for corporate control contrary to the spirit of Article 49 TFEU. Whereas its negative effect on shareholder value could be significant, the rule's potential to protect minority shareholders is rather limited.

#### **4.5 The Board Neutrality Rule**

Contained in Article 9 of the Directive, the board neutrality rule (BNR) requires the board of the target company – including the management board and the supervisory board where the target company has a two-tier board structure – to obtain prior authorisation of the general meeting of shareholders before *initiating* or *continuing* any action which could frustrate a

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<sup>55</sup> See RJ Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2006) 119 Harvard Law Review 1641, 1653 (arguing that '[g]ood law limits private benefits of control to amounts that are smaller than the increased productivity from more focused monitoring).

<sup>56</sup> Bergström, Högfeldt and Molin (n 48) 447.

<sup>57</sup> See Bergström, Högfeldt and Molin (n 48).

takeover bid.<sup>58</sup> The rule applies *at least* from the time the board receives information concerning the bid, until the outcome of the bid is made public or until the bid lapses. Member States may require the rule to take effect at an earlier stage, for instance, from the time the target board becomes aware that a bid is imminent.<sup>59</sup> Invariably, however, the requirement to obtain shareholder authorisation applies *ex post*, in the face of a bid. In other words, any authorisation must be bid-specific rather than general.

Article 9 of the Directive provides for three exceptions to the BNR. First, Article 9(2) permits the board to seek a white knight. Second, Article 9(3) permits the completion of measures taken within the company's normal course of business, provided such measures had been started pre-bid. Third, as we may recall from our discussion on bid-related disclosure requirements, Article 9(5) requires the target board to publish a statement giving its opinion on the merits of the proposed transaction.

#### **4.5.1 The Rationale for Board Neutrality**

Within the framework of market failures set out in Chapter 3, the BNR responds to agency problems between the target board and shareholders as a class. Its economic rationale is to ameliorate management-shareholder agency conflicts by preventing management from frustrating value-maximising takeovers through the adoption of defensive measures.<sup>60</sup> The strength of the rule mainly lies in the fact that it excludes any possibility for shareholders to grant pre-bid authorisation to the board to adopt defensive measures in the event of a bid.<sup>61</sup> Pre-bid authorisation is undesirable because it is impossible to assess beforehand whether a future bid would be value-maximising or not, and 'investors face a perception bias and information asymmetries before a takeover is announced.'<sup>62</sup>

Further, by allowing shareholders to vote on the merits of the bid, the BNR could mitigate the pressure to tender, thereby ensuring undistorted choice.<sup>63</sup> Undistorted choice might be achieved by the BNR even in the absence of actual cooperation among shareholders. Specifically, where the majority votes in favour of defensive measures, minority shareholders can predict the failure of the bid with more certainty and therefore may not be coerced into

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<sup>58</sup> Takeover Bid Directive (n 1), art 9(2) and (6).

<sup>59</sup> *Ibid*, art 9(2) (second paragraph).

<sup>60</sup> Goergen, Martynova and Renneboog (n 36) 257.

<sup>61</sup> See P Davies, E-P Schuster, and E van de Whalle de Ghelcke, 'The Takeover Directive as a Protectionist Tool?' in U Bernitz and W-G Ringe (eds), *Company Law and Economic Protectionism: New Challenges to European Integration* (OUP 2010) 109-12.

<sup>62</sup> Marccus Partners and Centre for European Policy Studies (n 7) 300.

<sup>63</sup> See LA Bebchuk 'The Case against Board Veto in Corporate Takeovers' (2002) 69 *University of Chicago Law Review* 973, 981-85.



tendering if they believe that the bid price does not fully reflect the value of their shares. The BNR can thus prevent value-decreasing control shifts from occurring.

#### 4.5.2 Deficiencies and Drawbacks

Despite the potential benefits of board neutrality in the event of a takeover bid, the European BNR is not watertight. First and foremost, in addition to Article 4(5) of the Takeover Bids Directive which allows Member States to derogate from the rules contained in the Directive on a case-by-case basis, Article 12 substantially dilutes the BNR by making provision for *optionality* and *reciprocity* exceptions. Article 12 has been understood as allowing Member States to treat the BNR in at least four different ways.<sup>64</sup> First, they can opt out of the rule altogether at national level. Where this option is chosen, the Member State concerned must allow publicly traded companies governed by its law to opt into the rule through a shareholder resolution, if they so wish. Here, national law *may* also specify whether or not companies that opt into the rule should qualify its application by a reciprocity exception (ie that the BNR would only apply in favour of bidders that are subject to the same rule). Second, Member States can adopt the BNR at national level but qualify it by the reciprocity exception. Third, Member States can adopt the BNR at national level but allow companies to apply the reciprocity exception. Fourth, Member States can adopt the BNR at national level in its strictest form (only subject to the three exceptions mentioned above).

As the Commission has observed, the latitude allowed by Article 12 coupled with the possibility under Article 4(5) for Member States to derogate from the provisions of the Directive has led to a variety of BNRs across Europe.<sup>65</sup> It has been established<sup>66</sup> that fourteen out of twenty-seven Member States (excluding Croatia)<sup>67</sup> have opted into the BNR without making the reciprocity exception available.<sup>68</sup> By contrast, five Member States<sup>69</sup> have not opted out but have made the reciprocity exception available. The remaining eight Member States<sup>70</sup> have opted out of the rule whilst making the reciprocity exception available to companies that may choose to adopt it. Out of these eight states, one (Italy) imposes board neutrality with the reciprocity exception as a default rule; that is, the rule applies unless it is disapplied at company level.

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<sup>64</sup> Davies, Schuster, and van de Walle de Ghelcke (n 61) 130-31; Marccus Partners and Centre for European Policy Studies (n 7) 302.

<sup>65</sup> Commission's 2012 Report (n 27), para 12.

<sup>66</sup> See Davies, Schuster, and van de Walle de Ghelcke (n 61) 136.

<sup>67</sup> Austria, Bulgaria, Cyprus, Czech Republic, Estonia, Finland, Ireland, Latvia, Lithuania, Malta, Romania, Slovakia, Sweden, and United Kingdom.

<sup>68</sup> Davies, Schuster, and van de Walle de Ghelcke (n 61) 136.

<sup>69</sup> France, Greece, Portugal, Slovenia, and Spain.

<sup>70</sup> Belgium, Denmark, Germany, Hungary, Italy, Luxembourg, Netherlands, and Poland.

Where Member States have opted out of the BNR, it is unlikely that any company would ever opt back in as the Directive does not provide any incentive for the corporate constituencies that may bring this to fruition (ie incumbent controllers) to do so. In fact, no company hitherto has been reported to have opted into the BNR.<sup>71</sup>

What this means in practice is that the BNR is non-existent in all the Member States that have opted out of the rule, perhaps except for Italy where the rule applies by default. Thus, public companies governed by the laws of these Member States can take defensive measures without shareholder approval unless the measures in question otherwise require shareholder authorisation and such authorisation has not been given in advance of a bid. Also, these companies cannot benefit from board neutrality if they launched a bid for a target based in any of the five Member States that have not opted out of the rule but have made the reciprocity exception available. Yet when a company governed by the law of any of the fourteen Member States that have adopted a strict BNR receives a bid, the board may not take defensive measures without shareholder authorisation. Companies governed by the laws of these fourteen Member States are therefore more open to the market for corporate control than those governed by the laws of Member States that have completely opted out of the BNR or indeed those that have not opted out but have adopted the reciprocity exception.

Obviously, this status quo goes against the very spirit of Article 49 TFEU, as read in conjunction with Article 54 TFEU, on the freedom of establishment. By now it is not a secret that it is generally less attractive to launch a bid for a target whose board enjoys discretion to implement defensive measures. We have also noted already that, absent legal restraint, the target board is likely to frustrate the transaction due to agency conflicts, in which case the bidder would suffer a loss in transaction costs without being able to acquire the target, to exercise the freedom of establishment.

The reciprocity exception which the Directive allows particularly flies in the teeth of the Treaty provisions. Articles 49 and 54 TFEU provide in no uncertain terms that all companies formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the EU must be afforded equal treatment whenever they elect to exercise the freedom of establishment.<sup>72</sup> But the reciprocity exception contained in Article 12(3) of the Takeover Bids Directive allows a Member State to afford

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<sup>71</sup> See Davies, Schuster, and van de Walle de Ghelcke (n 61) 145-147 (explaining why the option to opt in at company level is unlikely to be ever used in practice). See also Marcus Partners and Centre for European Policy Studies (n 7) 66, note 42 (stating that '[t]he option for companies to voluntarily opt-in the breakthrough and board neutrality rules is in practice never used').

<sup>72</sup> See Chapter 1, note 7 and accompanying text.

different treatment to bidders from other Member States that may not be subject to the BNR due to national political choices. As some commentators have observed, Article 12(3) in effect permits discrimination against foreign bidders from Member States that have opted out of the BNR.<sup>73</sup> Some may object to this observation and argue that the reciprocity exception is not discriminatory because companies are free to opt into the BNR. But a counterargument is that the discrimination remains intact until it is eliminated by individual companies opting into the rule through a shareholder resolution.<sup>74</sup> After all, as we have already noted, this option is inconsequential as it is never used in practice which means that the discrimination cannot be eliminated even by companies themselves.

In any event, the CJEU has made clear that the concept of ‘restriction’ for purposes of Article 49 TFEU covers measures taken by a Member State which, although applicable without distinction, affect access to the market for undertakings from other Member States and thereby hinder intra-Union trade.<sup>75</sup> The reciprocity exception therefore falls foul of the dictates of Article 49 TFEU regardless of whether it is discriminatory or not. It is also difficult to see how this exception would satisfy the principle of proportionality to redeem itself. To satisfy this principle, the exception (1) must be justifiable by overriding reasons in the public interest; (2) must be appropriate or suitable for ensuring the attainment of the objective in question; and (3) must not go beyond what is necessary to attain that objective.<sup>76</sup> What arguments then would one advance in favour of the reciprocity exception to satisfy these three conditions? To be sure, reciprocity is not needed; neither for the creation of an efficient European market for corporate control nor for the protection of minority shareholders.<sup>77</sup>

Indeed, had the Takeover Bids Directive not been in force, a national rule providing for reciprocity in the same manner as Article 12(3) does would probably have been objected to by the Commission because of its impact on both third-country bidders (in relation to free movement of capital) and bidders from other Member States (in relation to both the freedom of establishment and free movement of capital).<sup>78</sup> It therefore comes as no surprise that, although

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<sup>73</sup>J Winter ‘The Good, the Bad and Ugly of the European Takeover Directive’ in J Grant (ed), *European Takeovers: The Art of Acquisition* (1st edn, Euromoney Books 2005) 28; Mathias M Siems, ‘SEVIC: Beyond Cross-Border Mergers’ (2007) 8 EBOR 307, 315-16; Papadopoulos (n 14) 69.

<sup>74</sup> Siems (n 70) 315-16.

<sup>75</sup> Case C-400/08 *Commission v Spain* [2011] ECR I-1915, para 64.

<sup>76</sup> Case C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, para 37; Case C-371/10 *National Grid Indus* [2011] EU:C:2011:785, para 42 (see also cases cited therein); Case C-106/16 *Polbud — Wykonawstwo sp. z o.o., in liquidation* [2017] EU:C:2017:804, para 52.

<sup>77</sup> M Becht, ‘Reciprocity in Takeovers’ (2003) ECGI - Law Working Paper No 14/2003, 11 <<https://ssrn.com/abstract=463003>> accessed 25 April 2018.

<sup>78</sup> Davies, Schuster, and van de Walle de Ghelcke (n 61) 154.

many Member States already had a BNR in place before the Directive came into force, none of them had implemented a reciprocity exception.<sup>79</sup> But taking advantage of the green light given by the Directive, some of the Member States which had originally adopted a strict BNR have now gone back on their choice. Specifically, France, Greece, Portugal, Slovenia, and Spain have all discarded a strict BNR in favour of one qualified by reciprocity.<sup>80</sup> In terms of the sizes of the capital markets at stake, this represents a significant shift away from a bidder-friendly regime in the internal market.<sup>81</sup>

Moving away from the telling dilutive effect of Article 12 of the Directive, we must recall that the BNR does not prohibit takeover defences but merely transfers decision-making power on any defensive measures from the board to the shareholders.<sup>82</sup> This means that the rule is indifferent about the interests of non-controlling shareholders in a concentrated ownership environment where the controlling shareholder can extract private benefits.<sup>83</sup> Given that agency conflicts in such an environment arise between minority shareholders and the controlling shareholder, rather than between the board and shareholders as a class, the BNR falls short of addressing the inherent conflicts.<sup>84</sup>

In fact, by transferring the power to decide on defensive measures to the shareholders' meeting, the BNR might facilitate opportunistic behaviour by the controlling shareholder. The situation could even be worse if the controlling shareholder does not sit on the board and is thus unfettered by any fiduciary duties. Although controlling shareholders are not completely free from any responsibilities towards minority shareholders,<sup>85</sup> the controlling shareholder might vote in favour of defensive measures even against value-maximising bids to perpetuate its extraction of private benefits. As Ventoruzzo puts it in his fable, requiring board neutrality in these circumstances is tantamount to 'letting a fox guard a henhouse'.<sup>86</sup>

It must be admitted that the BNR is better than nothing even in a concentrated ownership environment.<sup>87</sup> First, the rule increases transparency in the adoption of defensive measures by transferring decision-making power to the shareholders' meeting. Second, by doing so, the rule offers an opportunity for minority shareholders to challenge the adoption by the majority of a

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<sup>79</sup> Ibid.

<sup>80</sup> Ibid, 139.

<sup>81</sup> Ibid, 140.

<sup>82</sup> Marccus Partners and Centre for European Policy Studies (n 7) 299.

<sup>83</sup> M Ventoruzzo, 'Takeover Regulation as a Wolf in Sheep's Clothing: Taking U.K. Rules to Continental Europe' (2008) 11 University of Pennsylvania Journal of Business Law 135; 159-60.

<sup>84</sup> Ibid.

<sup>85</sup> Ventoruzzo, 'Europe's Thirteenth Directive' (n 30) 215.

<sup>86</sup> Ventoruzzo, 'Takeover Regulation as a Wolf in Sheep's Clothing' (n 83) 160.

<sup>87</sup> Ibid.

resolution approving undesirable defences, an opportunity which may not otherwise be available if defences are adopted in the exercise of directorial discretion due to restrictions on shareholder suits<sup>88</sup> and, where applicable, due to the business judgement rule.<sup>89</sup> Third, the BNR might also be effective in a concentrated ownership environment if the controller or blockholders only enjoy de facto control deriving from pro rata equity investment, in the absence of CEMs.<sup>90</sup> This could be the case particularly where the law requires a supermajority of two-thirds of the shareholders to approve takeover defences, in which case minority shareholders might be able to block the adoption of undesirable defences, depending on the turnout at the shareholders' meeting.<sup>91</sup> None the less, the laws of Member States on voting thresholds are not harmonised in relation to all possible takeover defences.

In any event, the transfer of decision-making power to the shareholders' general meeting in the face of a takeover bid is problematic per se. We may recall from Chapter 3 that coordination among target shareholders increases the risk of free riding especially among blockholders.<sup>92</sup> Secondly, even though the BNR may reduce the pressure to tender, specifically where the majority votes in favour of defensive measures, if the majority votes against the adoption of defences, minority shareholders are liable to be even under more pressure to tender because they can predict the success of the bid with more certainty. It must also be mentioned in passing that coordination among shareholders when they are involved in the market for corporate control seems to fly in the teeth of competition law.<sup>93</sup> In short, insofar as it requires shareholders to convene at a general meeting to collectively decide on the acceptability of a takeover bid instead of allowing them to decide individually, the BNR might have a chilling effect on the exercise of the freedom of establishment through the market for corporate control.

We must also recall that the BNR's proscription of managerial defences in the absence of shareholder approval relates only to post-bid defences. By prohibiting post-bid defences whilst

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<sup>88</sup> See eg *Foss v Harbottle* (1843) 2 Hare 461; C Bradley, 'Corporate Control: Markets and Rules' (1990) 53 MLR 170, 178-81.

<sup>89</sup> See SM Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vanderbilt Law Review 83. The management-oriented business judgement rule is commonly known in the US. In *Unocal Corp v Mesa Petroleum Co* 493 A.2d 946 (Del 1985), the Delaware Supreme Court 'modified' the application of the rule in the context of control transactions due to inherent conflicts which arise in these transactions. But, see JJ Johnson and M Siegel, 'Corporate Mergers: Redefining the Role of Target Directors' (1987) 136 University of Pennsylvania Law Review 315 (arguing that the modification is superficial and inconsequential).

<sup>90</sup> Ventoruzzo, 'Europe's Thirteenth Directive' (n 30) 215; Davies, Schuster, and van de Walle de Ghelcke (n 61) 117-24.

<sup>91</sup> Ventoruzzo, 'Europe's Thirteenth Directive' (n 30) 215.

<sup>92</sup> Section 3.5.1. See also Marccus Partners and Centre for European Policy Studies (n 7) 72.

<sup>93</sup> See EB Rock, 'Corporate Law Through an Antitrust Lens' (1992) 92 Columbia Law Review 497; MA Utset, 'Disciplining Managers: Shareholder Cooperation in the Shadow of Shareholder Competition' (1995) 44 Emory Law Journal 71.

leaving pre-bid defences unscathed, the BNR could operate as an incentive for the adoption of pre-bid defences.<sup>94</sup> Even though it attempts to restrict managerial entrenchment in relation to post-bid defences, the BNR does not curtail managerial nest-feathering either. On the contrary, it facilitates it by expressly allowing the target board to seek a white knight.<sup>95</sup> Admittedly, target shareholders might benefit from the appearance of a white knight, especially if the white knight offers a significantly higher bid price than the black knight. But this might come at the expense of economic efficiency.

As we have noted in Section 3.4.1, any corporate board facing a takeover bid is unavoidably conflicted. Thus, a bidder invited by such a board might be seeking to advance the interests of the managers involved rather than to exploit synergies or otherwise to put the target assets to more efficient use. This might result in overpayment in favour of the target shareholders, including golden parachutes to the target board, at the expense of the shareholders of the bidding company. It is therefore difficult to find a compelling economic justification for the provision expressly permitting the board to seek a white knight. After all, interested competing bidders can emerge on their own even without the involvement of the board.<sup>96</sup> We must also recall that although bidding competition may lead to efficiency, it can also discourage potential bidders from searching for targets due to the free-rider problem associated with subsequent bidders who may buy the target without doing the work of searching, which entails sunk costs.<sup>97</sup>

A further concern relates to another of the three exceptions to the BNR. Specifically, Article 9(3) of the Directive poses interpretational problems insofar as it excludes the applicability of the BNR to actions which ‘form part of the normal course of the company’s business’. Controversy on the distinction between measures taken in the ‘normal course of business’ and those only aimed at frustrating takeovers may engender inefficient litigation.<sup>98</sup> A provision specifying the prohibited measures could perhaps be more helpful.

Lastly, Article 9(2) of the Directive is problematic insofar as it requires the BNR to take effect *at least* from the time the bidder’s intention to launch a bid is made public, whilst permitting Member States to adopt legislation which requires the rule to take effect from the time the board becomes aware of an *imminent bid*. The rationale for making the latter only

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<sup>94</sup> Davies, Schuster, and van de Walle de Ghelcke (n 61) 124.

<sup>95</sup> Takeover Bids Directive (n 1), art 9(2).

<sup>96</sup> Davies, Hopt, and Ringe (n 6) 214.

<sup>97</sup> M Kahan and M Klausner, ‘Lockups and the Market for Corporate Control’ (1996) 48 *Stanford Law Review* 1539; EB Rock ‘Antitrust and the Market for Corporate Control’ (1989) 77 *California Law Review* 1367; Davies, Hopt, and Ringe (n 6) 214-5;

<sup>98</sup> Ventrizzo, ‘Europe’s Thirteenth Directive’ (n 30) 209.

optional is not immediately palpable. Requiring the board to refrain from implementing defensive measures from the time it becomes aware of an imminent bid is obviously more bidder-friendly. In effect, this provision permits Member States to allow the board, after becoming aware of an imminent bid which is not yet public, to adopt defensive measures to foil takeovers.<sup>99</sup> This runs counter to the objective of fostering takeovers as a particular method of exercising the freedom of establishment of companies.

#### **4.6 The Breakthrough Rule**

The breakthrough rule (BTR) is provided for in Article 11 of the Directive. The rule applies sequentially at two stages of the takeover process. The first stage runs from the time the bid is made public to the time of its closure. During this period, any restrictions on the transfer of shares provided for in the articles of association of the target company, or in contractual agreements between the target company and its shareholders or the shareholders inter se, must ipso jure cease to apply vis-à-vis the bidder.<sup>100</sup> Where a general meeting of shareholders is convened during this period to vote on defensive measures in accordance with Article 9 of the Directive (on board neutrality), any such restrictions on voting rights as previously mentioned must remain suspended.<sup>101</sup> Further, at this meeting, any multiple-vote securities must carry only one vote each.

The second stage comes after the closure of the bid (post-bid). At this point, if the bidder holds 75% or more of the outstanding voting shares of the target company, any restrictions on the transfer of shares or voting rights as previously mentioned, including any extraordinary rights of shareholders concerning the appointment or removal of board members provided for in the articles of association of the target company, must cease to apply.<sup>102</sup> The bidder is entitled at this stage to convene the first post-bid general meeting of shareholders at short notice – of not less than two weeks – to amend the articles of association and/or to remove or appoint board members. Again, at this meeting, any multiple-vote securities must carry only one vote each.

Where any rights are removed during these stages, ‘equitable compensation’ must be provided for any loss suffered by the holders of those rights.<sup>103</sup> Member States enjoy discretion to set the terms for determining such compensation and the arrangements for its payment.

Article 11 of the Directive provides for two exceptions to the BTR. First, the rule does not

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<sup>99</sup> See Ventrizzo, ‘Europe's Thirteenth Directive’ (n 30) 209 (arguing that this is more appealing from the perspective of Member States as it would make their companies less susceptible to cross-border bidders).

<sup>100</sup> Takeover Bids Directive (n 1), art 11(1) and (2).

<sup>101</sup> Ibid, art 11 (3).

<sup>102</sup> Ibid, art 11 (4).

<sup>103</sup> Ibid, art 11 (5).

apply to restrictions on voting rights in relation to securities which are compensated for by specific pecuniary advantages.<sup>104</sup> That is, non-voting preference shares are not affected by the BTR.<sup>105</sup> Second, the BTR does not apply to the so-called ‘golden shares’ held by Member States in a target company and ‘other special rights’ provided for in national law, if such shares or rights are compatible with the Treaty.<sup>106</sup>

#### **4.6.1 The Rationale for the BTR**

We may recall from Section 4.5 above that the BNR does not catch pre-bid defences. The BTR attempts to fill this gap by limiting ‘the power and use of pre-bid takeover defences.’<sup>107</sup> According to the Commission, the BTR is aimed at measures that may result in managerial entrenchment and is not concerned about securities carrying double or multiple voting rights.<sup>108</sup> But in truth, the tentacles of the BTR reach both managerial entrenchment and controlling shareholder entrenchment, and the latter is even more directly affected than the former.

The BTR aims to ‘reverse’ during a takeover operation pre-bid measures adopted by board members and controlling shareholders structuring the rights of shareholders in a way that shields the company from hostile takeovers.<sup>109</sup> The rule can allow the bidder to bypass the incumbent controller, hence sparing the bidder the cost of paying a higher premium which the incumbent might ask for. In turn, this might make feasible value-increasing control shifts which would otherwise be frustrated either by the incumbent or by the MBR.<sup>110</sup> Thus, the BTR could even be more effective in facilitating takeovers in a concentrated ownership environment where the MBR is less stringent or, better still, completely absent.<sup>111</sup>

The proscription of restrictions on the transfer of shares during the bid period can foster the market for corporate control by allowing all shareholders to tender their shares without incurring any liability whether under shareholders’ agreements or under the provisions of the company’s articles of association or bylaws.<sup>112</sup> The ‘one share/one vote’ principle alias the proportionality principle might also ensure the effectiveness of board neutrality at the shareholders’ meeting convened in accordance with the BNR by dismantling CEMs which the controlling shareholder might use to approve defensive measures against value-maximising

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<sup>104</sup> Ibid, art 11 (6).

<sup>105</sup> Ventrizzo, ‘Takeover Regulation as a Wolf in Sheep’s Clothing’ (n 83) 166.

<sup>106</sup> Takeover Bids Directive (n 1), art 11 (7).

<sup>107</sup> Marccus Partners and Centre for European Policy Studies (n 7) 308.

<sup>108</sup> Commission of the European Communities, ‘Proposal for a Directive of the European Parliament and of the Council on Takeover Bids’ COM (2002) 534 final (Commission’s 2002 Proposal) 9.

<sup>109</sup> Davies, Hopt, and Ringe (n 6) 235.

<sup>110</sup> E Berglöf and M Burkart, ‘European Takeover Regulation’ (2003) 18 *Economic Policy* 171, 200

<sup>111</sup> Ibid.

<sup>112</sup> Ventrizzo, ‘Europe’s Thirteenth Directive’ (n 30).



bids.<sup>113</sup>

The post-bid breakthrough avails a successful bidder – that acquires 75% or more of voting rights – an opportunity to actualise control of the company through the suspension of any extraordinary rights of shareholders concerning the appointment and removal of board members. Coupled with the one share/one vote principle, this is intended to dismantle managerial entrenchment tactics by allowing the bidder to install a new board and ‘to amend the company’s constitution so that its voting power reflects its economic interest in the company.’<sup>114</sup>

Overall, the BTR is bidder-friendly. It can facilitate the exercise of the freedom of establishment of companies through takeovers by ameliorating agency conflicts in relation to both managerial entrenchment and controlling shareholder entrenchment.

#### **4.6.2 Deficiencies and Drawbacks**

A study conducted in 2004 had revealed that a significant number of European firms with dual class shares would be affected by the implementation of the BTR.<sup>115</sup> However, the BTR has barely had any impact at all. Like the BNR, the BTR is not a mandatory provision. The optionality and reciprocity latitude provided for by Article 12 of the Directive as explained in Section 4.5.2 above applies with equal force to the BTR. And quite apart from the questionable legality of the reciprocity exception as discussed in that section, optionality has been maximally exploited in relation to the BTR. In its report on the implementation of the Takeover Bids Directive, the Commission observed that only three Member States (Estonia, Latvia and Lithuania) had transposed the BTR.<sup>116</sup> The possibility to opt into the rule at company level has never been used either. This is mainly because ‘an opt-in at company level requires a supermajority vote of the shareholders in most cases, and’ the Directive does not provide any incentive for those possessing the technical advantage (ie controlling shareholders) to vote in favour, as doing so would be detrimental to their own interest in retaining control.<sup>117</sup> In short, the BTR is barely existent in practice.

But just how desirable is the BTR anyway? Indeed, there are several concerns which seem

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<sup>113</sup> Davies, Hopt, and Ringe (n 6) 236.

<sup>114</sup> Ibid.

<sup>115</sup> M Bennedsen and KM Nielsen, ‘The Impact of a Break-Through Rule on European Firms’ (2004) 17 *European Journal of Law and Economics* 259. cf JC Coates IV, ‘The Proposed ‘Break- Through’ Rule-Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?’ in G Ferrarini and others, *Reforming Company and Takeover Law in Europe* (2004 OUP) 677, 683–4 (providing a summary of data suggesting that only 4% of public firms in the EU would be affected by the BTR).

<sup>116</sup> Commission’s 2012 Report (n 27), para 3.

<sup>117</sup> Davies, Hopt, and Ringe (n 6) 236.

to significantly detract from the efficiency of the BTR and its potential facilitative effect on the exercise of the freedom of establishment.

To begin with, the BTR does not catch some of the CEMs and pre-bid defences which are prevalent in the EU, especially in continental Europe.<sup>118</sup> As noted above, non-voting preference shares are exempt from the BTR. Ceiling or time lapse voting shares, certificates for shares or non-voting depository receipts for shares, the use of proxies by conflicted financial (lending) institutions, share buybacks, pyramid structures and cross-shareholdings are other examples of technical barriers to the contestability of control which remain unscathed by the BTR.<sup>119</sup> Therefore, the implementation of the BTR could operate as an incentive for controlling shareholders relying on CEMs to switch to these entrenchment devices and resort to alternative – and perhaps more expensive – means of raising capital, other than issuing new voting shares.<sup>120</sup> The issuance of non-voting preference shares is also an open option. But this would still increase the cost of capital since such disenfranchisement is normally atoned for by a fixed dividend. In any event, provided that the necessary funds are available, the post-bid breakthrough can effectively be circumvented by raising one's blockholding just above the 25% threshold, since the rule only applies where the bidder is able to acquire at least 75% of voting rights.<sup>121</sup>

On the flip side, the BTR in its present form is worded too broadly.<sup>122</sup> The rule can affect economically essential agreements which incentivise the very involvement of stakeholders in the capital market or even takeover-friendly agreements. For example, pre-emption and option rights, sale agreements with deferred settlement, and lockups<sup>123</sup> (ie undertakings to accept a takeover offer) might be affected by the BTR.<sup>124</sup> The threat of 'breaking through' these 'normal market arrangements'<sup>125</sup> might create a 'hold-up' problem thereby increasing the cost of share capital, impeding entrepreneurship and the growth of the European single capital market.

Further, the BTR is a departure from a well-established and economically essential legal doctrine of *freedom of contract*, which is also a component of the freedom to conduct business

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<sup>118</sup> Ventrizzo, 'Takeover Regulation as a Wolf in Sheep's Clothing' (n 83) 166; Marccus Partners and Centre for European Policy Studies (n 7) 309.

<sup>119</sup> Papadopoulos (n 14) 57-61; B Sjaafjell, 'The Core of Corporate Governance: Implications of the Takeover Directive for Corporate Governance in Europe' (2011) 22 *European Business Law Review* 641.

<sup>120</sup> Berglöf and Burkart (n 110) 202; Bennedsen and Nielsen (n 115) 278; Coates (n 115) 683-4.

<sup>121</sup> Berglöf and Burkart (n 110) 202.

<sup>122</sup> Marccus Partners and Centre for European Policy Studies (n 7) 309.

<sup>123</sup> However, the efficiency of lockups is doubtful especially in cases where they in fact limit competition for corporate control. See Kahan and Klausner (n 97).

<sup>124</sup> V Edwards, 'The Directive on Takeover Bids – Not Worth the Paper It's Written On?' (2004) 1 *ECFR* 416, 437; Papadopoulos (n 14) 54.

<sup>125</sup> Edwards (n 124) 437.

enshrined in Article 16 of the Charter of Fundamental Rights.<sup>126</sup> The rule therefore requires a strong legal and/or economic justification to be sustained. The Commission acknowledged the mischief caused by this rule before the Directive came into force when it observed in its 2002 proposal that the ‘suppression’ of rights which the BTR entails ‘would in some legal systems give rise to questions of a constitutional nature’.<sup>127</sup>

The Directive attempts to remedy its own mischief by requiring, in Article 11(5), payment of ‘equitable compensation’ to the parties whose rights might be affected by the BTR. But when viewed in the light of the objective of fostering an active market for corporate control and the freedom of establishment, this attempt seems to be more harmful than not. As earlier noted, the Directive confers discretion on Member States and their supervisory authorities to decide *when* (the stage of the takeover process) and *how* (the criterion for determining quantum) the compensation should be determined. Importantly, the Directive does not provide any guidance as to *who* between the bidder and the target company would be required to pay the compensation.

These unclaritys create loopholes for protectionism, as experience has already shown in relation to the BNR. The lack of clear guidance on these issues might also lead to dilatory compensation assessment procedures, including expensive litigation, which may not only increase the pressure to tender<sup>128</sup> but also discourage potential bidders from launching bids.

The ‘Winter Group’ had recommended against requiring the bidder to pay compensation to those whose rights would be affected by the BTR.<sup>129</sup> But contrary to this recommendation and the objective of promoting takeovers and the freedom of establishment, the Directive effectively allows Member States to require the bidder to pay the compensation. Member States, especially those that favour protectionism, have every incentive to require bidders to pay compensation to discourage cross-border bids by complicating the takeover process, and by increasing the overall costs of bids.<sup>130</sup> Given this and all other probable adverse effects of the BTR as discussed above, the non-implementation of the rule by most Member States might just as well be a blessing in disguise.

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<sup>126</sup> Consolidated Version of the Charter of Fundamental Rights of the European Union [2016] OJ C202/389. See Case C-426/11 *Mark Alemo-Herron and Others v Parkwood Leisure Ltd* [2013] EU:C:2013:521, para 32.

<sup>127</sup> Commission’s 2002 Proposal (n 108) 9-10.

<sup>128</sup> See Papadopoulos (n 14) 65 (arguing that possible delays in determining compensation may leave shareholders with no alternative but to tender).

<sup>129</sup> J Winter and others, ‘Report of the High-Level Group of Company Law Experts on Issues Related to Takeover Bids’ (10 January 2002, Brussels) 35.

<sup>130</sup> See eg Ventoruzzo, ‘Takeover Regulation as a Wolf in Sheep’s Clothing’ (n 83) 167 (indicating that under Italian law equitable compensation must be paid by the bidder if the bid is successful, thereby increasing the overall cost of the bid).

## 4.7 The Squeeze-Out and Sell-Out Rights

The squeeze-out and sell-out rights are provided for respectively in Articles 15 and 16 of the Directive. The squeeze-out right entitles a bidder holding a ‘specified percentage’ of voting securities of a company *following a successful bid* for *all* voting securities to require the remaining minority holders of securities, within three months following the closure of the bid, to sell to the bidder their securities at a ‘fair price’. The sell-out right on the other hand is a *quid pro quo* of the squeeze-out right.<sup>131</sup> It entitles holders of the remaining securities when the squeeze-out threshold is reached to require the bidder, within three months following the closure of the bid, to buy their securities at a fair price.

The exercise of either right (squeeze-out or sell-out) is thus based on two conditions; that is, (1) the acquisition by the bidder of a specified minimum percentage of voting rights (*‘squeeze-out/sell-out threshold’*) following a nonpartial bid, and (2) the payment by the bidder of a *fair price*

### (a) *Squeeze-out/sell-out threshold*

The Directive makes provision for two alternative squeeze-out/sell-out thresholds from which Member States can choose one. The first is where, following a nonpartial bid – voluntary or mandatory – the bidder holds securities representing not less than 90% of the target company’s capital carrying voting rights and 90% of the voting rights, *irrespective of the acceptance rate* of the bid (hereafter ‘the single threshold’<sup>132</sup>). The second is where, following *acceptance* of a nonpartial bid – voluntary or mandatory – the bidder acquires or firmly contracts to acquire securities representing at least 90% of the target company’s capital carrying voting rights and 90% of the voting rights *comprised in the bid* (hereafter ‘the majority of the minority threshold’<sup>133</sup>).

The difference between the two is that the attainment of the majority of the minority threshold depends on the tender of at least 90% of the *voting rights* comprised in the bid, whilst the single threshold applies irrespective of the acceptance rate of the bid provided that the bidder’s total holding, including securities held prior to the bid, raises to at least 90% of voting shares and of any other voting securities. Moreover, Member States that choose the single threshold ‘may set a higher threshold that may not, however, be higher than 95% of the capital carrying voting rights and 95% of the voting rights’, an option which is not available to Member

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<sup>131</sup> Commission’s 2002 Proposal (n 108) 10.

<sup>132</sup> M Ventoruzzo, ‘Freeze-Outs: Transcontinental Analysis and Reform Proposals’ (2010) 50 *Virginia Journal of International Law* 841, 889.

<sup>133</sup> *Ibid*, 888.

States that adopt the majority of the minority threshold.<sup>134</sup>

Member States are required to make their own rules for calculating the threshold of their choice.<sup>135</sup> Where the target company has issued more than one class of securities, Member States may provide that the right of squeeze-out or sell-out can be exercised only in the class in which the applicable squeeze-out/sell-out threshold has been reached.<sup>136</sup> In other words, the Directive allows Member States to make provision for class squeeze-out/sell-out right.

*(b) Fair price*

Articles 15 and 16 of the Directive require Member States to ensure that a fair price is guaranteed in the event of squeeze-outs and sell-outs respectively.<sup>137</sup> The Directive does provide some guidance as to what would constitute a fair price. Specifically, it provides two rules in this regard, one concerning the *form* of consideration and the other concerning the *amount* of consideration to be paid.<sup>138</sup> As to the form, the ‘price’ must either take the same form as the consideration offered in the bid or cash, but Member States may require that cash be offered at least as an alternative. As to the amount, the Directive makes provision for two *presumptions*, depending on the type of bid that triggers the squeeze-out or sell-out right.

Where the squeeze-out or sell-out right has been triggered by a voluntary bid, the consideration offered in that bid is presumed to be fair if, through acceptance of the bid, the bidder has acquired securities representing not less than 90% of the capital carrying voting rights comprised in the bid. In other words, this presumption arises on situations where the triggering bid attains the ‘majority of the minority’ acceptance rate. But the presumption arises whether the applicable threshold triggering the squeeze-out or sell-out right is the majority of the minority threshold or the single threshold. None the less, if the acceptance rate of the triggering voluntary bid does not reach the majority of the minority threshold, no presumption of fairness arises. In this event, Member States must devise their own criteria for determining the amount of consideration that would constitute a ‘fair price’.

Where the squeeze-out or sell-out right has been triggered by a mandatory bid pursuant to Article 5 of the Directive, the consideration offered in that bid is presumed to be fair. As we may recall from Section 4.4 above, the price offered in a mandatory bid is not freely determined by the bidder.<sup>139</sup> Article 5(4) of the Directive requires the bidder to pay the highest price which

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<sup>134</sup> Takeover Bids Directive (n 1), arts 15(2) and 16(2).

<sup>135</sup> *Ibid*, arts 15(3) and 16(3).

<sup>136</sup> *Ibid*.

<sup>137</sup> *Ibid*, arts 15(5) and 16(3).

<sup>138</sup> Ventrizzo, ‘Freeze-Outs’ (n 132) 891.

<sup>139</sup> See also Ventrizzo, ‘Freeze-Outs’ (n 132) 891.

it had paid in a period, as determined by the Member State concerned, of between six and twelve months preceding the acquisition of control. And as already mentioned, such price may be adjusted upwards or downwards at the discretion of supervisory authorities in accordance with applicable national law.

#### **4.7.1 The Rationale for Squeeze-Out and Sell-Out Rights**

The squeeze-out and sell-out rights can eliminate agency conflicts between majority and minority shareholders as the exercise of either right may result in the transfer of full ownership of the company to the bidder.<sup>140</sup> But these two rights are primarily designed to address coordination problems.

##### *(a) The squeeze-out right*

Consider the squeeze-out right first. This right mitigates the incentive for shareholders to hold on to their shares in an attempt to free ride.<sup>141</sup> Thus, the squeeze-out right allocates a larger portion of takeover gains to the bidder.<sup>142</sup> Crucially, the opportunity to squeeze-out minority shareholders is an important consideration for most bidders, especially hostile ones.<sup>143</sup> More often than not, corporate acquisitions are pursued with a view to acquire full control of the target company, to delist it and turn it into a wholly owned subsidiary or subsume it through a merger operation. This is mainly motivated by some strategic, financial, tax, and legal benefits attend to the acquisition of full ownership and going private.<sup>144</sup> In other words, full ownership is generally more valuable than mere majority ownership. The bidder might even condition the bid on the acceptance rate equal to the applicable squeeze-out threshold to ensure that it is able to acquire full ownership.<sup>145</sup>

But this could be an incentive for minority shareholders to keep their shares, knowing that the bidder would be willing to offer a higher price for residual shares to realise the benefits of full ownership after a successful takeover.<sup>146</sup> The squeeze-out right attempts to eliminate this incentive insofar as it presumes the consideration offered in the triggering bid to be fair. Where this presumption applies, the law does not account for the present value of the consideration at the time of the squeeze-out, which means that minority shareholders are better off tendering at

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<sup>140</sup> Goergen, Martynova, and Renneboog (n 36) 252.

<sup>141</sup> Van der Elst and Van den Steen, 'Squeezing Out and Selling Out' (n 50) 196; Marccus Partners and Centre for European Policy Studies (n 7) 314.

<sup>142</sup> Marccus Partners and Centre for European Policy Studies (n 7) 314.

<sup>143</sup> Ventruruzzo, 'Freeze-Outs' (n 132) 914.

<sup>144</sup> See Van der Elst and Van den Steen, 'Squeezing Out and Selling Out' (n 50) 198-99; Ventruruzzo, 'Freeze-Outs' (n 132) 847-50; I Martinez and S Serve, 'The Delisting Decision: The Case of Buyout Offer with Squeeze-Out (BOSO)' (2011) 31 *International Review of Law and Economics* 228.

<sup>145</sup> Burkart and Panunzi (n 38) 19.

<sup>146</sup> Van der Elst and Van den Steen, 'Squeezing Out and Selling Out' (n 50) 199.

the bid price than waiting to be squeezed out later at the same price. Consequently, the bidder might be able to acquire the target company at a lower price when the bid is conditional on the squeeze-out threshold, since shareholders may not gain anything from keeping their shares.<sup>147</sup>

All in all, the squeeze-out right can be a decisive factor in a takeover operation. It can affect the potential bidder's incentives to launch a bid, *ex ante*, and the success of the bid, *ex post*. This is supported by evidence confirming the popularity of squeeze-outs.<sup>148</sup> The squeeze-out right is therefore a key element in fostering the market for corporate control and the freedom of establishment.

*(b) The sell-out right*

Consider the sell-out right in turn. This right protects minority shareholders by ameliorating the pressure to tender.<sup>149</sup> It affords minority shareholders an opportunity to 'compel' the new controlling shareholder to buy their shares post-bid. Thus, the sell-out right can reduce fears among target shareholders who may be dissatisfied with the bid price (1) that the value of their shares would be diluted post-takeover through the bidder's opportunistic extraction of private benefits, and/or (2) that the market in their shares would become illiquid post-takeover.<sup>150</sup> Insofar as it requires the sell-out price to be the same as that offered in a preceding voluntary or mandatory bid, the law reassures shareholders that, if they are not satisfied with the bid price, they can hold on to their shares and still sell them later at a 'fair price' if the transaction goes through against their wish. In turn, this can reduce the pressure to tender and prevent inefficient and value-decreasing takeovers. Even if the Directive does not account for the time value of money, the three months' period which it allows for the exercise of the sell-out right ensures – when the sell-out threshold is reached – that minority shareholders are able to sell their shares in the shortest possible time.

In a nutshell, the sell-out right provides protection for minority shareholders and therefore can contribute to the reduction in the cost of capital. Also, by reducing the pressure to tender, this right can contribute to ensuring undistorted choice thereby leading to both distributive and allocational efficiency.

#### **4.7.2 Deficiencies and Drawbacks**

The squeeze-out and sell-out rights can easily be reconciled. Both rights seek to promote economic efficiency. But the attempt by these two provisions to strike a balance between the

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<sup>147</sup> Goergen, Martynova and Renneboog (n 36) 252.

<sup>148</sup> Martinez and Serve (n 144); Marccus Partners and Centre for European Policy Studies (n 7) 315.

<sup>149</sup> Ventoruzzo, 'Freeze-Outs' (n 132) 193-94.

<sup>150</sup> See Van der Elst and Van den Steen, 'Squeezing Out and Selling Out' (n 50) 202.

promotion of an active market for corporate control (through the squeeze-out right), on one hand, and the protection of minority shareholders (through the sell-out right), on the other hand, can produce contradictory outcomes. As mentioned above, the squeeze-out right promotes takeovers by ameliorating the free-rider problem, thereby allocating more takeover gains to the bidder at the expense of minority shareholders. The fear of being squeezed out may result in the pressure to tender. The quid pro quo offered by the sell-out right may not fully resolve the problem especially if the sell-out price is uncertain. This is likely to be the case, specifically, where the presumed fair price is inapplicable (ie where the sell-out right is triggered by the single threshold rather than by the majority of the minority threshold, following a voluntary nonpartial bid). In any event, a shareholder may not know beforehand whether the acceptance rate of the bid would reach the majority of the minority threshold.

Questions have also been raised as to the constitutionality of the squeeze-out right vis-à-vis the shareholders' property rights in their shares.<sup>151</sup> However, there seems to be *general* consensus that, provided 'the right applies only when the minority is fairly small and appropriate compensation is offered, the use of squeeze-out' is legally justifiable by 'general and public interest in having companies efficiently managed on the one hand, and securities markets sufficiently liquid on the other hand.'<sup>152</sup>

The sell-out right too can produce its own inefficiencies. As we have alluded to above, this right offers minority shareholders a larger part of takeover gains by forcing the bidder to buy out minority shares. Despite the potential benefits of squeezing out minority shareholders, some bidders (especially SMEs) may be financially constrained or may otherwise prefer not to delist the target company. In such cases, the sell-out right can discourage a potential bidder from bidding. The sell-out right can therefore be seen as a functional equivalent of the MBR, since both provisions compel the controlling shareholder to buy out minority shares.

The sell-out right could also encourage free-riding behaviour as minority shareholders may reasonably anticipate a higher price to follow in the squeeze-out or sell-out, since the bid price is not always presumed to be fair. Thus, the latitude given to Member States to determine the squeeze-out or sell-out price on a case-by-case basis can either lead to the pressure to tender (where the minority shareholder fears that the squeeze-out price would be lower than the bid price) or free-riding behaviour (where the minority shareholder anticipates the sell-out or squeeze-out price to be higher than the bid price). The latter just like the pressure to tender can

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<sup>151</sup> cf Ventoruzzo, 'Freeze-Outs' (n 132) 911 (observing that in the US – in contrast to continental European jurisdictions – corporate shares are not seen as constituting property rights).

<sup>152</sup> See Van der Elst and Van den Steen, 'Squeezing Out and Selling Out' (n 50) 207.



produce inefficiencies, even if the bidder may be able to acquire control. Specifically, if many shareholders decide to withhold their shares, the number of shares tendered may not reach the sell-out/squeeze-out threshold. This outcome might be damaging not only to the bidder, but also to the company and to minority shareholders,<sup>153</sup> particularly if a fair bid price is offered.

Hitherto, we have identified one loophole in the tenor of Articles 15 and 16 of the Takeover Bids Directive in relation to the squeeze-out and sell-out rights respectively. That is, the extent to which the Directive allows Member States to devise their own criteria for determining the squeeze-out or sell-out price leaves room for uncertainty. In fact, this latitude has resulted in the adoption by Member States of various procedures for determining the ‘fair price’ on a case-by-case basis. The procedures include, for example, appraisals by national supervisory authorities, independent experts and national courts.<sup>154</sup> Hence the collective action problems which Articles 15 and 16 respond to are not satisfactorily addressed and the parties’ transaction costs might be increased by the various price determination procedures which different Member States have adopted.

There are several other loopholes in the tenor of these two provisions. Still on the squeeze-out/sell-out price, we may recall that the Directive provides that the price offered in a mandatory bid, or in a voluntary bid (provided that the majority of the minority acceptance rate has been reached), is presumed to be fair. This reduces transaction costs for the parties by obviating the need to engage in costly assessment procedures. But the Directive does not indicate whether the presumption of fairness of price is rebutted nor not. Although some believe that it is not,<sup>155</sup> the lack of clarity on this issue might engender avoidable litigation.

Moreover, insofar as the presumption of fairness is based on a 90% acceptance rate of the triggering bid, the Takeover Bids Directive deviates from its objective of fostering takeovers and the freedom of establishment. The Directive ‘grants excessive relevance’ to the position of small minority shareholders,<sup>156</sup> potentially leading to the loss of efficiency which would otherwise be generated from a lower threshold. It also furthers the entrenchment of controlling shareholders by limiting minority shareholders’ opportunity to sell out their shares as the

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<sup>153</sup> Ventruruzzo, ‘Freeze-Outs’ (n 132) 193.

<sup>154</sup> Commission of the European Communities, ‘Commission Staff Working Document: Report on the implementation of the Directive on Takeover Bids’ SEC (2007) 268 <[http://ec.europa.eu/internal\\_market/company/docs/takeoverbids/2007-02-report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/takeoverbids/2007-02-report_en.pdf)> accessed 18 April 2018. See also C van der Elst and L Van den Steen, ‘Balancing the Interests of Minority and Majority Shareholders: A Comparative Analysis of Squeezed-out and Sell-out Rights’ (2009) 6 ECFR 391 (discussing, inter alia, the assessment procedures for a ‘fair price’ adopted in Belgium, France, The Netherlands, the UK and Germany).

<sup>155</sup> See Ventruruzzo, ‘Freeze-Outs’ (n 132) 892-93.

<sup>156</sup> *Ibid*, 916.

attainment of an acceptance rate of 90% is far-fetched.

Turning to the triggering thresholds, we may recall that the Directive makes provision for two different thresholds that can trigger the squeeze-out and sell-out rights, namely the single threshold and the majority of the minority threshold. We may also recall that Member States may adopt either of these two thresholds. Both thresholds require the bidder to hold at least 90% of the capital of the company carrying voting rights. But Member States that opt for the single threshold are given further latitude to raise the squeeze-out/sell-out threshold to 95% of the capital carrying voting rights and 95% of the voting rights. This is probably because it is *relatively* easy to reach the single threshold since it requires a holding of 90% of voting rights without more, whilst the majority of the minority threshold requires, in addition to that, an acceptance rate of at least 90% of the voting rights comprised in the triggering bid.<sup>157</sup> None the less, the 90% threshold seems to be too high to warrant any further upward adjust.

Although a lower threshold would probably be contrary to the constitutional right to property, a very high threshold conflicts with the economic efficiency hypothesis.<sup>158</sup> The potential benefits of both the squeeze-out and sell-out rights are lost if the triggering threshold is so high that it can hardly ever be reached in practice. Yet some Member States, including the largest economies in continental Europe, which have adopted the single threshold have set the threshold triggering the squeeze-out/sell-out right at the highest level allowed by the Directive ie 95%.<sup>159</sup> This runs counter to the objective of facilitating the exercise of the freedom of establishment through an active single market for corporate control.

Another deficiency in relation to the triggering thresholds is that the voting securities which fall within the ambit of the two thresholds are rather limited. Specifically, the tenor of the Directive does not seem to capture securities potentially carrying voting rights such as bonds-cum-warrants, convertible bonds or other securities that give access to securities with voting rights.<sup>160</sup> Given that the squeeze-out right seeks to grant the bidder the opportunity to acquire full ownership of the target company, the failure by the EU legislature to explicitly capture all forms of securities akin to equity detracts from the very purpose of the right. This also holds true vis-à-vis class squeeze-outs which the Directive provides for. By the same token, class sell-outs could detract from the protection of minority shareholders as some shareholders may be deprived of an opportunity to sell out their shares.

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<sup>157</sup> Ibid, 889.

<sup>158</sup> Van der Elst and Van den Steen, 'Squeezing Out and Selling Out' (n 50) 207.

<sup>159</sup> Ventoruzzo, 'Freeze-Outs' (n 132) 897.

<sup>160</sup> Van der Elst and Van den Steen, 'Balancing the Interests of Minority and Majority Shareholders' (n 154).

Lastly, the protection of minority shareholders could be undermined by national corporate squeeze-out procedures which fall outside the scope of the post-takeover squeeze-outs provided for by the Takeover Bids Directive.<sup>161</sup> The lack of integration of these squeeze-out procedures create regulatory fragmentation within the internal market which could also operate as a barrier to the exercise of the freedom of establishment through takeovers as some Member States are more liberal than others in permitting corporate squeeze-outs.

#### **4.8 Conclusion**

This chapter has examined how the response, or lack of response, by the Takeover Bids Directive to the regulatory problems identified in Chapter 3 could affect potential bidders' incentives and/or ability to conduct successful cross-border takeover operations. This has been done in pursuit of the second objective of the study. It has been established that, other than disclosure requirements which could be beneficial to all stakeholders, the Directive does not contain specific rules aimed at addressing agency problems which might arise in the bidding company or those which could affect creditors of the target company. The Directive instead focuses on addressing agency problems and coordination problems in relation to the constituencies of the target company by making provision for (1) disclosure of certain information, (2) mandatory bids, (3) board neutrality in the face of a takeover bid, (4) a possibility to break-through certain takeover barriers, and (5) post-bid squeeze-out and sell-out rights. In pursuit of the third objective of the study, this chapter has also brought to light a number of deficiencies and drawbacks of these provisions. The analysis strongly suggests that virtually each of these provisions could be improved in one way or another to make it more attractive and practicable for potential bidders to exercise the freedom of establishment through cross-border takeovers, whilst ensuring economic efficiency.

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<sup>161</sup> Van der Elst and Van den Steen, 'Balancing the Interests of Minority and Majority Shareholders' (n 154) 394-99; Ventruruzzo, 'Freeze-Outs' (n 132) 900-02.

## **5 Conclusion and Recommendations Towards Efficient Regulation**

### **5.1 Introduction**

Thus far, this study has addressed three of its four objectives. Chapter 3 has identified the regulatory problems which takeover rules should respond to. These are agency problems which may arise between the constituencies of both the bidding company and the target company, and coordination problems which mainly affect target shareholders. In Chapter 4, we have seen that the European Takeover Bids Directive<sup>1</sup> focuses on addressing these problems insofar as they affect the constituencies of the target company. We have explained in Section 4.2 of that chapter that the Directive does not contain specific rules aimed at addressing agency problems which may affect the bidding company because such problems relate to corporate strategy and are therefore addressed by general corporate governance law. We have also seen in Chapter 4 that the various provisions of the Directive – relating to disclosure requirements, mandatory bids, board neutrality during takeover bids, the possibility to break-through certain takeover barriers, and post-bid squeeze-out and sell-out rights – which are designed to address agency and coordination problems in relation to the target company have some deficiencies and downsides which could detract from the efficiency of the market for corporate control. We have further shown that this could negatively affect the exercise of the freedom of establishment of companies through cross-border takeovers, as enshrined in Articles 49 and 54 TFEU<sup>2</sup>.

This chapter concludes the study by providing some recommendations on how the Takeover Bids Directive could be improved, to facilitate the exercise of the freedom of establishment of companies through takeovers in a more efficient manner. But it should be underscored from the outset that despite the many deficiencies and drawbacks of the key provisions of the Directive identified in Chapter 4, a level of harmonisation of European takeover rules that would fully satisfy the efficiency hypothesis is unattainable in practice. In any event, there is a virtually insurmountable hurdle in harmonising takeover rules across Europe because, as our analysis in Chapter 4 has shown, rules that may work well in one corporate governance system may produce opposite and undesirable effects when applied in a different context.<sup>3</sup> And as Enriques

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<sup>1</sup> Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids [2004] OJ L142/12 (Takeover Bids Directive).

<sup>2</sup> Consolidated Version of the Treaty on the Functioning of the European Union [2016] OJ C202/47 (TFEU).

<sup>3</sup> M Goergen, M Martynova and L Renneboog. 'Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe' (2005) 21 Oxford Review of Economic Policy 243, 263; M Ventrizzo, 'Takeover Regulation as a Wolf in Sheep's Clothing: Taking U.K. Rules to Continental Europe' (2008) 11 University of Pennsylvania Journal of Business Law 135, 172.

argues ‘even leaving aside the question of whether it would be desirable to have a uniform EU company law, that outcome is simply impossible to achieve, due to interest group resistance and the variety in national meta-rules’.<sup>4</sup>

Cross-border takeover regulation is particularly controversial. To put it into perspective, it is important to recall the history of the Takeover Bids Directive. The legislative process that culminated in the adoption of the Directive was tortuous.<sup>5</sup> About fifteen years passed from the time the first draft of the Directive was tabled by the Commission to the time when the final draft was adopted on 21 April 2004. The first draft could not garner enough support to pass under the Article 294 TFEU<sup>6</sup> (ordinary) legislative procedure. Several amendments were made to the initial draft before the Directive saw the light of day. The Directive therefore represents a significant compromise<sup>7</sup> and it is unlikely that a ‘complete’ reform would now be welcomed. It should also be noted that there are several reform proposals that have already been made by some preeminent scholars.

This chapter therefore does not attempt to reinvent the wheel or to replicate what has already been suggested by others. Rather, it seeks to build on existing scholarship and propose additional reforms which appear realistic for the time being, considering the historical background which has led us to the status quo. Accordingly, the chapter proceeds as follows. The next section calls for the enhancement of disclosure requirements as a way of addressing pre-bid takeover defences, in place of the largely problematic BTR. Section 5.3 observes that despite its dubious economic justification and potential inefficiencies, the MBR is so entrenched in the laws of Member States that it is unlikely to be discarded or significantly watered down. Section 5.4 recommends that the task of draw up an opinion on a public takeover bid as provided for by Article 9(5) of the Directive should be entrusted to independent experts instead of the board of the target company. Section 5.5 calls for the EU legislature to consider transforming the MBR into a sell-out right. Section 5.6 then makes final concluding remarks.

## **5.2 Enhancing Disclosure Requirements in Place of the BTR**

The strength of the breakthrough rule (BTR) lies in its potential to dismantle certain pre-bid measures with defensive qualities (ie certain departures from the one share/one vote principle

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<sup>4</sup> L Enriques, ‘A Harmonized European Company Law: Are We There Already?’ (2017) 66 ICLQ 763, 763.

<sup>5</sup> See V Edwards, ‘The Directive on Takeover Bids – Not Worth the Paper It’s Written On?’ (2004) 1 ECFR 416, 418-32; T Papadopoulos, ‘Infringements of Fundamental Freedoms within the EU Market for Corporate Control’ (2012) 9 ECFR 221, 223 (giving an account of the history of the Directive).

<sup>6</sup> Then Article 251 TEC.

<sup>7</sup> M Ventrizzo, ‘Europe’s Thirteenth Directive and U.S. Takeover Regulation: Regulatory Means and Political Economic Ends’ (2006) 41 Tex Int’l LJ 171, 174.

and certain restrictions on the transfer of voting securities) which the BNR fails to do. Thus, the Commission's 2002 proposal for a directive on takeover bids contained a mandatory BTR to supplement a mandatory BNR.<sup>8</sup> But as we have seen in Chapter 4, both rules ended up in the Directive as optional provisions<sup>9</sup> and the BTR has barely been transposed into national law by Member States.

Three possible explanations can be given for the lack of transposition of the BTR by most of the Member States. First, unlike the BNR which had already been adopted by many Member States before the Directive came into force, a comprehensive BTR 'was known in no Member State before the Directive was adopted, with the possible exception of Italy.'<sup>10</sup> It is thus probable that Member States were sceptical about experimenting with an alien rule. Second, economic protectionism could also have had a key role to play since the implementation of the BTR could make cross-border takeovers easier especially in continental Europe where CEMs are common. Third, Member States might have refrained from adopting the BTR due to its potential detrimental effect on the efficient functioning of capital markets and due to its questionable constitutionality as discussed in Section 4.6.2. A mandatory BTR is therefore unlikely to be adopted at EU level. In fact, the Commission has already made clear its reluctance to make either the BTR or the BNR mandatory.<sup>11</sup>

For our purposes, it must be stressed that an efficient and freely functioning European single capital market cannot be sacrificed in the name of fostering takeovers and the freedom of establishment. This study therefore postulates that the economic objectives of the BTR could be more efficiently achieved through enhanced pre-bid disclosure requirements. We may recall that Article 10 of the Takeover Bids Directive requires disclosures of control and ownerships structures. These include certain departures from the one share/one vote principle and certain restrictions on the transfer of voting securities, both of which are also targeted by the BTR. But disclosure requirements are more specific and capture some CEMs such as cross-shareholdings and pyramid structures which the BTR fails to capture. Importantly, the specificity of disclosure requirements also means that some agreements which form part of normal market practice are

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<sup>8</sup> Commission of the European Communities, 'Proposal for a Directive of the European Parliament and of the Council on Takeover Bids' COM (2002) 534 final (Brussels, October 2002) (Commission's 2002 Proposal), arts 9 and 11.

<sup>9</sup> Takeover Bids Directive (n 1), arts 9 and 11 as read together with art 12.

<sup>10</sup> P Davies, E-P Schuster, and E van de Whalle de Ghelcke, 'The Takeover Directive as a Protectionist Tool?' in Ulf Bernitz and Wolf-Georg Ringe (eds), *Company Law and Economic Protectionism: New Challenges to European Integration* (OUP 2010) 124-25.

<sup>11</sup> 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' COM (2012) 347 final (Commission's 2012 Report), paras 26.

not affected by disclosure obligations in the same manner as they would be affected by the BTR. The requirements to make public and justify the existence of pre-bid defences provided for by Article 10(2) and (3) of the Directive coupled with the potential effect of disclosures on the creditworthiness of companies and their attractiveness to investors could ensure that only commercially justifiable pre-bid defensive measures are adopted by companies. This would render the BTR largely redundant and even more undesirable as ‘breaking-through’ commercially justifiable shareholder rights cannot be justified even by the need to foster the freedom of establishment through the market for corporate control.

In short, with enhanced pre-bid disclosures, the BTR could be repealed. All that needs to be done is to ensure that all potential pre-bid defences are disclosed accurately and timeously. This would also entail requiring Member States to put in place rigorous enforcement mechanisms.

### **5.3 The MBR as an Entrenched but Inefficient Rule?**

The mandatory bid rule (MBR) is seen by its proponents as indispensable to achieve a trade-off between promoting takeovers and protecting minority shareholders. But as we have seen in Chapter 4, although the rule could prevent inefficient control transactions, it could also harm rather than protect minority shareholders whilst perpetuating inefficiency. Thus, some critics are of the view that the MBR should be repealed or substantially watered down, whilst others argue that it should ‘be retained but only as a non-binding norm with full discretion being left to the general meeting of shareholders of the (target) company or in the company statutes.’<sup>12</sup> Hopt, however, believes that both proposals are unrealistic because the MBR is so widely accepted that it had been part of the takeover rules of many Member States (following the UK’s lead) well before the Takeover Bids Directive came into force and is now fully established in all Member States.<sup>13</sup>

Although our analysis favours a regime without a MBR, this observation is convincing. In addition to the fact that the MBR is entrenched in the laws of Member States, the rule also furthers protectionism in the field of corporate takeovers. Thus, Member States are unlikely to accept any proposal to significantly water it down, let alone to repeal it. Nevertheless, quite apart from the proposals that have already been made to fine-tune the rule as indicated in the Commission’s 2012 report<sup>14</sup> and as suggested by some scholars,<sup>15</sup> this study calls for further

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<sup>12</sup> KJ Hopt, ‘European Takeover Reform of 2012/ 2013— Time to Re-examine the Mandatory Bid’ (2014) 15 EBOR 143, 166.

<sup>13</sup> *Ibid.*

<sup>14</sup> Commission’s 2012 Report (n 11), paras 23-25.

<sup>15</sup> see Hopt (n 12) 172-88 (outlining the issues which have been proposed for fine-tuning).

consideration of ‘the missing link’ between the MBR and the sell-out right. This is elaborated in Section 5.5 below.

#### **5.4 Amending Article 9(5) – an Exception to the BNR**

Like the MBR, the EU’s board neutrality rule (BNR) was modelled on the UK’s City Code on Takeovers and Mergers and had been part of the takeover rules of many Member States even before the Takeover Bids Directive was adopted.<sup>16</sup> But unlike the MBR which has a chilling effect on the market for corporate control, the BNR can play a leading role in fostering the freedom of establishment through takeovers, as demonstrated in Section 4.5. However, any hope of adopting a mandatory BNR at EU level was lost when the Commission’s 1996 proposal for a takeover bids directive was rejected in 2001 by the European Parliament during the final stage of the legislative process, primarily because it contained a mandatory BNR.<sup>17</sup> Therefore, as some have observed, a mandatory BNR at EU level is not attainable.<sup>18</sup> The main reform proposal which has been made in relation to this rule is that board neutrality should be a default requirement; that is, that the BNR should apply unless the shareholders choose to disapply it by ordinary resolution.<sup>19</sup> It remains to be seen whether this proposal will be considered by the Commission in due course.

Meanwhile, this study considers that both the BNR and bid-related disclosures required by Articles 6 and 8 of the Directive would be more effective if Article 9(5) made provision for a trusteeship strategy to further ameliorate agency problems.<sup>20</sup> Our proposal here is that, instead of requiring the board of the target company to draw up a document setting out its opinion on the merits of the bid, this task should be entrusted to independent experts.

As can be inferred from our discussion in Chapter 4, there are several justifications for this proposal. First, in the face of a takeover bid the target board is invariably conflicted and as such is likely to be biased in its opinion. Second, the board’s opinion in this regard could have a major influence on the tender decision of unsophisticated investors who may be grappling with asymmetric information and/or failure to properly assimilate the disclosed information. An additional advantage of an independent opinion is that it could be beneficial not only to the target shareholders but also to the shareholders of the bidding company, and the creditors and employees of the target company.

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<sup>16</sup> Edwards (n 5) 418-20; Davies, Schuster, and van de Walle de Ghelcke (n 10) 141.

<sup>17</sup> Davies, Schuster, and van de Walle de Ghelcke (n 10) 106.

<sup>18</sup> *Ibid*, 158.

<sup>19</sup> *Ibid* 158-60.

<sup>20</sup> See P Davies, K Hopt, and W-G Ringe, ‘Control Transactions’ in R Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 219-20.



Further, since the requirement to publish an opinion even in its current form is a stand-alone requirement (ie an exception to the BNR) which applies whether the board is subject to the BNR or not, an independent expert opinion could somewhat deter management from adopting defensive measures unless the bid has received a negative opinion. This is so because the directors could find themselves in breach of their fiduciary duties if they were to adopt defensive measures and it later turned out that the bid received a clean bill of health from experts. A trusteeship strategy in form of an independent expert opinion on the merits of the bid could therefore operate at least as a second-best alternative to the BNR where the rule does not apply.

Thankfully, it seems that amending Article 9(5) in the manner suggested by this study would not be as contentious as amending the BNR itself. EU corporate merger law makes provision for a requirement like the one proposed here. Specifically, it requires merging companies to commission independent expert reports on the fairness of the substantive terms of a proposed merger before the proposal is put to a vote at the shareholders' general meeting.<sup>21</sup> Therefore, there appears to be no reason why Member States would take exception to the introduction of a similar requirement under takeover law.

## **5.5 Finding the Missing Link Between the MBR and the Sell-Out Right**

The deficiencies and drawbacks affecting the efficiency and effectiveness of the squeeze-out and sell-out rights which we have discussed in Section 4.7 have been explored at length by Van der Elst and Van den Steen,<sup>22</sup> and Ventoruzzo.<sup>23</sup> These three scholars have made several passionate appeals for reform to address the deficiencies of Articles 15 and 16 of the Takeover Bids Directive, which need not be rehashed here.

Meanwhile, this study notes an apparent missing link between the MBR contained in Article 5 of the Directive and the sell-out right contained in Article 16. Our discussion in Chapter 4 has shown that to *some extent* the MBR and the sell-out right have different economic rationales. The former is *primarily* concerned with agency problems between controlling and minority

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<sup>21</sup> Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law (codification) [2017] OJ L169/46, art 96 (applicable to domestic mergers of public companies) and art 125 (applicable to cross-border mergers); Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE) [2001] OJ L294/1, art 22.

<sup>22</sup> C van der Elst and L Van den Steen, 'Balancing the Interests of Minority and Majority Shareholders: A Comparative Analysis of Squeezed-out and Sell-out Rights' (2009) 6 ECFR 391. See also C Van der Elst and L Van den Steen, 'Opportunities in the Merger and Acquisition Aftermarket: Squeezing Out and Selling Out' in GN Gregoriou and L Renneboog (eds), *Corporate governance and Regulatory Impact on Mergers and Acquisitions* (Elsevier 2007).

<sup>23</sup> M Ventoruzzo, 'Freeze-Outs: Transcontinental Analysis and Reform Proposals' (2010) 50 Virginia Journal of International Law 841.

shareholders, whilst the latter is *primarily* concerned with the pressure-to-tender problem.<sup>24</sup> But we have seen that the implications of the two provisions on the market for corporate control, particularly on bidders' incentives, are similar. Specifically, both rules reduce the share of takeover gains allocated to the bidder and thus could discourage some value-increasing takeovers. This negative economic effect derives from one common denominator; that is, both rules afford an opportunity (rather than an obligation) to minority shareholders to sell their shares, whether the buyer likes it or not.

But whereas the MBR imposes an obligation on the buyer to instigate the purchase through a general offer to all shareholders, the sell-out right is exercisable by the shareholders on their own volition. Given the characteristics of a typical takeover bid which we have identified in Chapter 3, particularly in relation to coordination problems and transaction costs, it appears that efficiency would be *better* served by a sell-out right than by a public bid. Whether it applies post-bid or after an acquisition of control through other acquisition techniques, a sell-out right could ensure that shareholders sell their shares only when they deem it necessary to do so.

This could be beneficial to long-term investors who may otherwise be coerced into selling their shares in a mandatory bid against their wish due to the pressure to tender, thereby also saving the acquirer the cost of launching a bid and buying shares which are not necessary to exercise control. It must be reiterated that not all controlling shareholders are inefficient. As Gilson observes, in jurisdictions with 'good law', controlling shareholders can be efficient monitors of management for the benefit of minority shareholders.<sup>25</sup> Therefore, there appears to be no need to pressure minority shareholders, through a public bid, to sell their shares whenever there is a change of control under the guise of protecting them.

In short, our proposal is that the MBR should be 'transformed' into a sell-out right. This proposal is different from other proposals calling for the repeal of the MBR or watering it down. A sell-out right could be more effective and efficient in ensuring the attainment of the main objective of the MBR ie the protection of minority shareholders from exploitation at the hands of a new controlling shareholder through excessive extraction of private benefits of control. As explained above, the chilling effect of the MBR on the market for corporate control (and the freedom of establishment) could also somewhat be ameliorated by transforming the MBR into a sell-out right as this would reduce the partial acquirer's financial burden.

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<sup>24</sup> See M Burkart and F Panunzi, 'Mandatory Bids, Squeeze-Outs, Sell-Out and the Dynamics of the Tender Offer Process' (2003) ECGI Law Working Paper No 10/2003, 20-21 (discussing the differences between the two rules).

<sup>25</sup> RJ Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2006) 119 Harvard Law Review 1641, 1653.

## 5.6 Conclusion

The European Parliament ‘[u]nderlines that the [Takeover Bids] Directive provides for a level playing field for takeover bids in Europe and believes that, in the long term, further improvements could be envisaged to strengthen this level playing field’.<sup>26</sup> However, this study has established that the playing field for takeover bids in Europe is quite far from being level. Maximally exploiting the transposition latitude offered by the Directive, Member States have adopted a wide variety of national rules in the field of takeover bids some of which run counter – and conspicuously so – to the very *raison d’être* of the Directive. This regulatory fragmentation means that the regulatory problems or market failures affecting the market for corporate control are not addressed in a satisfactory manner across Europe. Although wholly uniform takeover rules are probably neither attainable nor tenable at EU level, a certain level of harmonisation is still needed. As things stand, the efficiency of the European market for corporate control is largely undermined. This could significantly impede the exercise by companies of the freedom of establishment through cross-border takeover operations. Building on existing scholarship, in pursuit of the fourth and last objective of this study, this chapter has made several recommendations in this regard which could contribute to the facilitation of the exercise of the freedom of establishment in a more efficient manner.

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<sup>26</sup> European Parliament Resolution of 21 May 2013 on the application of Directive 2004/25/EC on takeovers bids (2012/2262(INI)) [2016] C55/01, para 5.

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