The Use of Defensive Measures in Hostile Takeovers

A COMPARATIVE STUDY OF TAKEOVER REGULATION
IN THE US, THE UK, CANADA, THE EU AND GERMANY

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ABSTRACT

This Master's Thesis is a comparative study of the regulation of defensive measures in hostile takeovers. It consists of two main parts: In the first, the subject is approached from a theoretical point of view. The relevant factors for the regulation of defensive measures are outlined and analysed, followed by a discussion of the different ways of drafting such rules. This part concludes with a proposition concerning the most favourable form and content of a regulation. The second part describes hostile takeover regulation in the US, the UK, Canada, the EU and Germany, showing the diversity in that field of regulation in practice and the underlying reasons. It highlights and assesses the characteristics of each country and its regulation in the light of the considerations made in the first part, and provides an outlook concerning the future development of the regulation of defensive measures in hostile takeovers.

Cette thèse de maîtrise est une étude comparative des réglementations des mesures défensives contre une acquisition hostile. Elle comporte deux parties principales: D'abord, le sujet est abordé d'un point de vue théorique. Les facteurs essentiels pour les réglementations des mesures défensives sont décrits et analysés, suivi par une discussion des modes différents de concevoir de telles règles. Cette partie se termine par une proposition concernant la forme et le contenue le plus favorable d'une réglementation. La deuxième partie décrit la réglementation des acquisitions hostiles dans les Etats-Unis, la Grande-Bretagne, le Canada, l'Union Européenne et l'Allemagne, démontrant la diversité réglementaire dans la pratique, et les raisons pour ces différences. Elle clarifie et évalue les caractéristiques de chaque pays et de ses réglementations suivant les considérations retenues dans la première partie, et donne une perspective du développement future des réglementations concernant les mesures de défenses contre les acquisitions hostiles.

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A. INTRODUCTION

The regulation of management's defensive measures in hostile takeovers has already been the topic of numerous articles and books in various countries[1]. Since the phenomenon of hostile takeovers occurred first in the United States in the 1960s, and grew strongly in the 1980s, it was treated extensively especially in American legal literature, mainly since the second half of the 1980s. A flood of court decisions and statutes regulated this subject. Therefore, it seems like the question of the use of defensive measures in hostile takeovers has already been treated exhaustively, particularly in the United States, which probably has the most experience with hostile takeovers. So why should it now be the subject of this thesis?

There are several reasons. First of all, due to the only recent major occurrence of hostile takeovers in Europe, and the attempts to regulate them, the question is at the height of its relevance in Europe. In 1999, the announced hostile deals worldwide totalled over $473 billion, representing 14 per cent of all announced deal value, while the hostile bids announced in Europe accounted for 75 per cent of that sum[2]. This shows how the use of hostile bids has become much more common in Europe. In the US, hostile takeovers were mainly opposed in the 1980s but started to become accepted in the 1990s[3]. Many European countries recently seem to have undergone a similar development.

Germany plays a special role in this context. Hostile takeovers were traditionally seen as detrimental to the economy, and as an expression of bad business manners. This rigorous point of view was shaken in 2000 by the successful hostile takeover of Mannesmann, a German telecom and steel company, by Vodafone, an English telecom company. This was the biggest takeover so far, being worth 371.0 million DM[4]. After that, a big discussion about the positive and negative effects of hostile takeovers was triggered, and

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[1] A hostile takeover is defined as a takeover which is opposed by the management of the target company, see B.I.

[2] J.H. Flom, "Mergers and Acquisitions: The Decade in Review" (2000) 54 U. of Miami L. Rev. 753 at 761-762.

[3] *Ibid.* at 762.

[4] „Die großen Firmenübernahmen" *Frankfurter Allgemeine Zeitung* (02/05/2001).

the German government immediately took steps to enact a law governing hostile takeovers. After three different drafts, the "Gesetz zur Regelung von öffentlichen Angeboten zum Erwerb von Wertpapieren und von Unternehmensübernahmen" came into force on 1 January 2002. Whether this statute can remain in force in its current form depends on the outcome of the negotiations concerning the contents of a European Directive regulating hostile takeovers, the 13th Directive on Company Law. If a European Directive contradicting the new German statute gets enacted, Germany has to adapt its national legislation to the European Directive[5].

The creation of a Directive harmonizing the regulation of hostile takeovers was initiated in 1988. In July 2001, the European Parliament voted – with a majority of one vote – against the enactment of the final draft. The driving force of that rejection was Germany, which did not agree with the Directive's regulation of defensive measures. At first, Germany agreed with the European Directive's restriction of management's abilities to use defensive measures substantially, which was also expressed in the first drafts of the German statute. Later, Germany changed its position, and wanted to give the management more power in defeating a hostile takeover, which was reflected in the enacted statute of 1 January 2002. Now, the European Union plans a new draft of the Directive, which will probably not appear until fall 2002[6].

These developments show that discussions about the treatment of defensive measures in hostile takeovers will continue for a long time in Europe. Even if many European countries have already created hostile takeover regulations in different forms, they might become obsolete in the future, depending on the outcome of the Directive.

The second reason why this subject is relevant is that, because of the involvement of European countries in an increasing number of cross-border transactions and hostile takeovers, it has new importance for the US. In 1999, international cross-border activity had grown from a transaction volume of $61.1 billion in 1991 to $814.3 billion. This

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[5] See *Treaty establishing the European Community*, Art. 249.
[6] „Brüssel schont Bundesregierung und VW" *Süddeutsche Zeitung* (25/02/2002).

represented approximately 25% of the total transaction volume of $3.18 trillion in 1999[7]. This figure rose to 41 per cent in 2000[8]. European merger activity accounted for 37 per cent of the total transaction volume in 1999 (including national and international transactions)[9]. It seems like the merger wave starting in the beginning of the 1990s, the fifth large one in the US, is at the same time the first big international merger wave[10]. This wave is especially characterized by high transaction volumes, globalization, the high involvement of Western European countries as well as the frequent occurrence of hostile takeovers[11]. However, due to the recent global economic downturn, considerably fewer mergers and takeovers could be observed in 2001. Compared to the year 2000, the entire M&A transaction volume decreased in 2001 at 52 per cent[12]. However, cross-border transactions still account for 37.5 per cent of that volume, and the participation of European countries, especially Germany and the United Kingdom, remains high[13].

For the US, it is therefore relevant what the regulation in European countries is or will be, since targets in Europe form a large part of the American international acquisition strategy[14]. Also, this development is reason for the US to rethink its own regulation, since both major economic blocks, North America and Europe, have to consider harmonizing their treatment of defensive measures to keep equal conditions and support international transactions in an increasingly global market. This trend towards the internationalization of business will continue due to the following factors: increased possibilities to raise capital, less trade barriers, improved technology and communication, the loosening of regulatory restrictions, growing privatization and the consolidation of the European market[15]. Furthermore, hostile takeovers themselves might play an important role in that development.

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[7] Flom, *supra* note 2 at 755, 763.
[8] „KPMG-Studie zu grenzüberschreitenden Firmenübernahmen" *AG Report* (2001) R73 at R73.
[9] Flom, *supra* note 2 at 764.
[10] B.S. Black, "The First International Merger Wave (and the Fifth and Last US Wave)" (2000) 54 U. of Miami L. Rev. 799 at 799.
[11] „Endet die fünfte Welle auf dem Markt für Unternehmensübernahmen in einer neuen Rezession?" *Frankfurter Allgemeine Zeitung* (4.10.2000).
[12] „Mergers and Acquisitions im Jahr 2001" *AG Report* (2002) R46 at R46.
[13] *Ibid.* at R47.
[14] Flom, *supra* note 2 at 765-766.
[15] *Ibid.* at 774-775.

When assessing the way defensive measures should be regulated, it should be remembered that they are more than a detailed aspect of takeover regulation, but instead have much wider consequences. The extent to which management can defeat a hostile takeover consequently influences the frequency of the occurrence and the success of hostile takeovers in an economy[16]. Therefore, not only the duties of management in the situation of a hostile takeover have to be examined, but also the role and costs of hostile takeovers in the economy in general. Consequently, hostile takeovers must be examined under both economic and legal aspects. Therefore, in most legal discussions about the treatment of hostile takeovers, economic theories have played an important role. Since the phenomenon of hostile takeovers occurred first in the United States, the economic discussion focuses on the circumstances there. However, it has been adapted and further developed in other countries as well. In examining the legal and economic arguments in this discussion, several factors have to be considered, such as the remaining national differences and the changed business environment, including globalization and improved means of communication. In the end, both the finding of common principles and the comparison of national characteristics as well as the consideration of the need of harmonization can give an indication which way regulation should go.

In light of these considerations, this thesis is structured in the following manner: First, in chapters B to D, it approaches the subject from a theoretical point of view. After having established in chapter B the opportunities that the directors actually possess to defeat a hostile takeover, it assesses all the factors which are relevant to the regulation of defensive measures on a legal and economic basis in chapter C. These include the interests of the parties directly concerned, especially those of the shareholders of the target company. But also the general merits of hostile takeovers for the companies and the economy shall be taken into account, since their perception of being rather useful or detrimental influences the decision of whether the use of means to defeat them should be supported or restricted. Chapter D will deal with the appropriate manner in which to regulate defensive measures, taking into account the considerations made in Chapter C.

[16] H. Merkt, "Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen" (2001) 165 ZHR 224 at 225.

The possible forms and contents of hostile takeover regulation will be examined. In that context, it is also a concern as to whether the regulation of defensive measures can be assigned to corporate law or rather to securities law, and which authority would be the one best suited to establish and govern such a regulation.

In the second part of the thesis, hostile takeover regulations in different countries, especially the regulation of the use of defensive measures, will be assessed. Chapter E considers countries which have already a considerable history of hostile takeovers and consequent regulation, such as the United States, the United Kingdom and Canada. Their individual characteristics and regulation will be outlined, and it will be shown that often additional factors to the ones elaborated in the first part play an important role in shaping a regulation. The same is true for chapter F, which describes the attempts to enact a European Directive to harmonize takeover regulation in the EU and the underlying discussions, as well as the recently enacted takeover statute in Germany. This chapter shows how the subject is approached by regulatory authorities which actually have, or had only recently, the opportunity to decide how such a regulation should take form. This shall be considered in the light of the pre-existing regulations outlined in chapter E, and goes on to examine which factors especially influenced their decisions.

The final conclusion will summarize the result of the foregoing chapters, and will provide an outlook and a proposal as to how the future development of the regulation of defensive measures in hostile takeovers should and would look like.

B. POSSIBILITIES FOR THE MANAGEMENT TO DEFEAT A HOSTILE TAKEOVER

Before assessing the merits and costs of hostile takeovers and the extent to which directors should be allowed to apply defensive measures, it should be outlined what possibilities the directors theoretically have to influence the outcome of a hostile bid.

I. Shareholders' rights and directorial power

In large public companies, shareholders usually delegate authority to lead the company to a professional management from whose expertise they profit[17]. Nevertheless, as the owners of the company, they retain the right to ultimately decide whether to sell their shares or not. This ability is normally not restricted, either legally or in practice. This might be different in the situation of a hostile takeover.

A hostile takeover is characterized by the fact that it is initiated and pursued against the will of the directors of the target company, in contrast to a friendly takeover, where the management agrees with the takeover[18]. If the directors oppose a hostile takeover and therefore try to prevent it from happening, they can actually have a substantial influence on its success. They can achieve this result in several ways.

First, the management of the target company can give a recommendation to the shareholders whether to accept the offer or not - in many countries this is even established as a duty. Due to the directors' advantage in expertise and information, the shareholders might rely on that recommendation. This usually concerns small, non-institutional shareholders, since large and institutional shareholders tend to keep themselves well informed, and either have their own expertise or use professional advisors. On the other hand, the management of the bidder company often gives out information and recommendations concerning the bid as well. If the shareholders of a company are widely

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[17] F.H. Easterbrook & D.R. Fischel, "Corporate Control Transactions" (1982) 91 Yale L. J. 698 at 700 [hereinafter "Corporate Control Transactions"].

[18] S.C. Lese, "Preventing Control from the Grave: A Proposal for Judicial Treatment of Dead Hand Provisions in Poison Pills" (1996) 96 Colum. L. Rev. 2175 at 2175.

dispersed, and the efforts to convince the shareholders to keep or sell their shares reach a certain stage such as extended media campaigns, they might have a noticeable effect on the decisions of the shareholders. This does not necessarily prevent the shareholders from making their own judgement – on the contrary, correct and objective information might help them to make a reasoned decision based upon their own understanding of the facts[19]. To ensure this and to avoid misuse, many countries already have enacted regulations.

The most important and efficient way for the management to defeat a hostile takeover, however, is the use of defensive measures, which go further than just offering an opinion to the shareholders. Defensive measures are designed to either render the acquisition of the target company extremely difficult, usually by raising the costs or imposing impediments to obtain control, or to make the target company too unattractive to the bidder[20]. Their use does not always lead to the total defeat of the hostile bid, but can also lead to the acquisition of the company at a higher price either by the original or another bidder[21].

II. Classification and forms of defensive measures

There is a wide range of possible defensive measures. Depending on corporate law and other regulations, they differ from country to country. A special regulation concerning defensive measures in hostile takeovers can range from a substantial restriction of their use to giving additional means of defence. Apart from that, it is mostly general corporate law which allows or forbids the use of certain defensive measures. Additionally, the use of some of them, even if they are permitted by law, can be limited by practical considerations and the lack of acceptance by the capital market if they are not shareholder-value oriented[22].

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[19] K.J. Hopt, "Verhaltenspflichten des Vorstands bei feindlichen Übernahmen" in *FS Lutter* (Köln: O. Schmidt, 2000) 1361 at 1383 [hereinafter „Verhaltenspflichten"].

[20] M. Sikora, "Defensive Tactics" in M.L. Rock, ed., *The Mergers and Acquisitions Handbook* (New York: McGraw-Hill Book Company, 1987) 467 at 467.

[21] F.H. Easterbrook & D.R. Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harvard L. Rev. 1161 at 1162 [hereinafter "The Proper Role"].

[22] D. Becker, „Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen" (2001) 165 ZHR 280 at 281f.

One of the most well known defensive measures which was developed in the US is the shareholder rights plan, which is also called "poison pill". Poison pill is a metaphor because if it is triggered, the acquisition of a target company can become so expensive that the bidder cannot swallow it[23]. In a certain event, especially the acquisition of shares by a bidder exceeding a certain percentage without the approval of the board, the shareholders can exercise rights to receive significant economic value from the company[24], especially in form of shares and/or other securities. The bidder himself can be excluded from exercising this right, which makes it even more efficient[25]. There now exist many different variations of poison pills.

Other forms of defensive measures mainly used in the US, but also partly in other countries, include the sale of essential corporate assets ("crown jewel defence", also known in its extreme form as "scorched earth approach"), the acquisition of the company's own shares from the bidder at a higher price ("green mail"), clauses in contracts which give the right to withdraw in the case of a change of control, as well as bids in turn for the shares of the hostile bidder ("Pac Man defence")[26]. "Golden parachutes", which often have the form of contracts between the company and its management providing for compensation of the management in case it has to resign in the aftermath of a hostile takeover, however, might often have an adverse effect. Due to the possibility of a high compensation, the management might be less worried about the loss of its position in the case of a hostile takeover and therefore not oppose it as it otherwise would[27].

In addition to the defensive measures listed above, there are many other possible defensive measures, especially ones which are less drastic and more likely to be accepted even by restrictive regulations.

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[23] A. Weisner, *Verteidigungsmaßnahmen gegen unfreundliche Übernahmeversuche in den USA, Deutschland und nach europäischem Recht* (Münster: Lit Verlag, 2000) [hereinafter „Verteidigungsmaßnahmen"] at 20.
[24] Lese, *supra* note 18 at 2179.
[25] A. Weisner, "Dead-hand-Bestimmungen in der US-amerikanischen Rechtsprechung – ein Überblick" (2001) RIW 191 [hereinafter „Dead-hand-Bestimmungen"] at 193.
[26] "Verhaltenspflichten", *supra* note 19 at 1388-1389.
[27] S.L. Emanuel, *Corporations,* 3rd ed. (Larchmont, NY: Emanuel Publishing Corp., 1997-98) at 488.

In general, defensive measures can be classified into poison pills, shark repellents (provisions in the target's articles of incorporation or bylaws that include staggered board provisions, super-majority requirements to approve a merger between the target and large shareholders as well as fair price provisions)[28], other contractual arrangements for the event of a hostile takeover (such as golden parachutes or control clauses), financial announcements (such as profits and dividends announcements), corporate restructuring (such as asset disposals and acquisitions), share purchases (of the target's own or the bidder's shares), share issues and legal or political proceedings (such as the accusation of the breach of legal regulations, including corporate law, takeover regulation and antitrust law, as well as political lobbying)[29].

The search for a "white knight" after the first bidder launches a hostile offer, meaning another bidder usually more acceptable to the management, is in fact not a defensive measure itself[30], even though some statutes regulating defensive measures regard it as one[31]. Its main purpose is not to defeat the threat of being taken over itself, but to enlarge the number of possible acquirers who finally engage into an auction. Therefore, it aims to result in an acquisition[32], not a defence.

There is also a distinction between pre-bid and post-bid defensive measures, which are measures taken before and after the announcement of a hostile bid.

Another important classification of defensive measures, especially in the context of management duties and shareholders' rights, is the distinction between whether the implementation or use of a defensive measure requires shareholder approval or not[33]. This is independent from any special takeover regulation, since shareholders usually have the right to participate in important business decisions. Defensive measures involving

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[28] „Dead-hand-Bestimmungen", *supra* note 25 at 193.
[29] See also T. Jenkinson & C. Mayer, *Hostile Takeovers: Defense, Attack and Corporate Governance* (London: McGraw-Hill Book Company, 1994) at 29ff.
[30] "Verhaltenspflichten", *supra* note 19 at 1383.
[31] See e.g. §33 WpÜG.
[32] Jenkinson & Mayer, *supra* note 29 at 32.
[33] See G. A. Jarrell, J.A. Brickley & J. M. Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980" (1988) 2 Journal of Economic Perspectives 49 at 59ff.

amendments of the target's articles of incorporation, such as shark repellents, are mostly dependent on the approval of the shareholders. On the other hand, the implementation of a shareholder rights plan, which can also be implemented after a hostile bid, does not normally require shareholder approval[34]. Sometimes, however, shareholders are able to give advance approval to defensive measures, in case a hostile bid will occur in the future, which will deprive them of their right to decide in the concrete case.

[34] Emanuel, *supra* note 27 at 512.

C. FACTORS RELEVANT TO THE REGULATION OF DEFENSIVE MEASURES IN HOSTILE TAKEOVERS

In this chapter, the different aspects which have to be taken into account when considering the regulation of the use of defensive measures in hostile takeovers will be outlined. First, it has to be established which parties are directly affected in the situation of a hostile takeover, and which interests have to be taken primarily into account. This will be done in part I of this chapter. Before that, the general conflict of interests between the management as the agents and the shareholders as the principals, which is enhanced in the situation of a hostile takeover, will be outlined. The existence of this conflict not only leads to the fact that the relevant interests have to be determined, but also that their consideration has to be ensured. This conflict of interests is not only relevant in the face of a concrete offer, but also in the context of the general use of hostile takeovers, as will be shown below. In parts II, III and IV, the usual merits and costs of hostile takeovers in the economy and for a company, considering the reflections made in part I, will be outlined and weighed against each other to assess whether the general policy should be to support or hinder them. Only then can it be decided whether defensive measures, as a powerful device influencing hostile takeovers, should be restricted or encouraged.

I. The underlying conflict of interests

1. The principal-agent conflict

In a public company, the shareholders, who are the principals, usually delegate the authority to lead the company to the directors, their agents[35]. Due to this division of ownership and leadership, a conflict of interests between the shareholders and the management can occur. This conflict, which is inherent in any agency relationship, is based on the presumption that people act to enhance their individual benefits, which sometimes differ from each other[36]. At the same time, agency relationships are governed

[35] "Corporate Control Transactions", *supra* note 17 at 700.

[36] M. C. Jensen & W. H. Meckling, „Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 Journal of Financial Economics 305 at 308; 305, citing A. Smith, *The Wealth of Nations*, 1776, Cannan Edition (New York: Modern Library, 1937) at 700.

by fiduciary duties, requiring that the agents act in the interests of the principals[37]. The theory of the principal-agent-conflict and the problem of fiduciary duties and opportunistic behaviour, which has initially been developed in the US by economic theorists, form one of the starting points of the discussion of the treatment of defensive measures in hostile takeovers.

Attempts have been made to align the interests of the directors with those of the stockholders by providing directors with incentive compensation arrangements, such as stock options or bonuses based on profits[38]. This, however, neither eliminates nor substantially diminishes the conflict of interests, since the directors often only hold a small stake in the company so that their gains as directors might exceed their losses made at the same time as shareholders[39].

The principal-agent conflict plays two roles in the discussion of how to regulate the use of defensive measures. First, it has to be determined whose interests are to be served in the event of a takeover itself, taking into account the possible conflict of interests between the management and the shareholders. The conflict is especially strong in this situation, since the directors of a company are often in danger of losing their position afterwards[40]. There is also the question of whether other partly conflicting interests have to be considered, such as the ones of the employees of the company[41]. In this situation, the purpose of the regulation of defensive measures would be to balance the affected interests.

Second, the threat of a possible loss of their position due to a hostile takeover can act as a means to control the management in its strategic and business decisions on a day-to-day basis. In this case, the extent to which defensive measures are available to the management determines how big the threat would be, and correspondingly the extent of control to ensure that its actions are aimed at meeting the interests of the company and its

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[37] "Corporate Control Transactions", *supra* note 17 at 700.
[38] W.A. Klein & J.C. Coffee, *Business Organization and Finance: Legal and Economic Principles*, 4th ed. (1990: New York, The Foundation Press, Inc.) at 160.
[39] "Corporate Control Transactions", *supra* note 17 at 701.
[40] See C.I.2.a).
[41] See C.I.2.c).

shareholders, rather than being determined by self-interest[42]. This aspect will be treated in part II of this chapter, where the general merits of hostile takeovers are outlined.

2. Conflicts of interest in a hostile takeover

a) Directors' interests

When the attempt is made to take over a company, the management is regularly threatened to lose its position after the hostile takeover, because the new owner often wants to replace it with a management of his choice in order to pursue his own business strategy. Since the management is only authorized to lead the company in the interests of the shareholders, and maybe the ones of the stakeholders, such as employees[43], the personal interests of the management shall not play any role in its decisions throughout the takeover attempt. Nevertheless, the practice proves that in reality this is often the case[44]. One purpose of takeover regulation is therefore to ensure that the management looks after the interests of the shareholders, and maybe stakeholders, rather than its own.

b) Shareholders' interests

(1) The effect of defensive measures upon the shareholders

First, it will be outlined how shareholders can be affected by the use of defensive measures, and which particular interests are concerned.

The shareholders, as the owners of the company, have a strong interest to keep the ultimate power to decide whether they want to sell their shares to realize gains, to invest in another corporation in case the bidder pays with its own shares, or to retain their investment in the original company. Management's defensive measures can make the acquisition too costly or unattractive to the bidder so that he withdraws his offer. This

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[42] See C.II.1.
[43] For a definition and a discussion of the stakeholders' interests see C.I.2.c).

deprives the shareholders of their choice and the chance to benefit from a high takeover premium, which is the difference between the market price and the amount paid by the bidder for the control of the company.

Defensive measures do not necessarily lead to this consequence, but can also cause the price offered to be increased. Since the interests of the shareholders do not only concern the likelihood of an offer with a premium, but also the amount of the premium itself[45], the use of defensive measures might in this way also have a desirable effect for the shareholders of the target company. However, there are risks involved. A strategy to raise the price offered by the bidder might cause the bidder not to pursue the takeover[46]. Also, if the prices for hostile takeovers generally increase without eventually being covered by the gains, less takeover attempts will occur in the future[47]. As a consequence, a higher frequency of takeovers often comes along with lower premiums, and the other way around[48].

On the other hand, especially price enhancing defensive measures can eventually raise the value of a company[49]. Therefore, even if the shareholders cannot realize this value through a higher premium, they might benefit in the long term from increasing share prices.

(2) Different groups of shareholders and their special interests

It also has to be taken into account that different groups of shareholders pursue different interests, depending on what their motives are to invest in a certain company.

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[44] C. Kirchner, „Managementpflichten bei „feindlichen" Übernahmeangeboten" (2000) 1821 at 1822 [hereinafter „Managementpflichten"].
[45] J.C. Coffee, "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 Colum. L. Rev. 1145 at 1175.
[46] "The Proper Role", *supra* note 21 at 1175.
[47] *Ibid.* at 1176.
[48] Coffee, *supra* note 45 at 1156.
[49] C. Kirchner, „Szenarien einer „feindlichen" Unternehmensübernahme: Alternative rechtliche Regelungen im Anwendungstest" (2000) BB 105 at 109 [hereinafter „Szenarien"].

Some shareholders have a purely financial interest in the company. They are either private or institutional investors, who often invest capital on behalf of their members. Both of them mainly focus on maximizing their financial returns and are less interested in a long-term strategy[50]. It is therefore in their interest to achieve high control premiums and realize their investment when it seems the most favourable. In some countries, however, there are also large non-strategic investors, who have more than just a financial interest in holding stakes in a company. This is, for example, the case for German banks and insurance companies, who often are at the same time creditors of the company and therefore want to keep their influence as shareholders on the management of the company.

Apart from these special cases, there are other shareholders who are generally interested in keeping their investment in the company and supporting the pursuit of a long-term strategy. These include shareholders with strategic interests in holding a stake in the company and employees, who hold shares as part of a compensation scheme[51]. For them, it is very important to have more extended internal control mechanisms since the sale of their stake is not the most preferable option. Therefore, they are more interested in a "right of voice" than in a "right of exit"[52]. Nevertheless, this does not necessarily lead to them being entirely opposed to hostile takeovers, which could also support their goals. If they do not sell their shares during a hostile takeover and remain as minority shareholders, they could profit from a new management which might enhance the efficiency of the company, although this might result in the loss of future influence on the company. Even if the company is not eventually taken over, the threat alone might cause the current management to increase the value of the company[53]. Still, as a consequence, the management might focus more on counterproductive short-term strategies[54].

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[50] K.J. Heiser, „Can Capital Market Law Approaches be Harmonized with Essential Principles of Company Law?" (2000) European Bus. L. Rev. 60 at 69.
[51] Heiser, *supra* note 50 at 70.
[52] *Ibid.* at 74.
[53] See C.II.1.c).
[54] See C.III.1.

Another shareholder interest in the course of a hostile bid is not to be confronted with unfair bidder tactics, but with a well-structured and transparent process that does not put any of the shareholders at a disadvantage. Defensive measures could protect shareholders from detrimental bidding methods[55]. However, since in many countries unfair procedures are forbidden or restricted (e.g. by determining the offer period and disclosure requirements, the treatment of two-tier bids and partial bids as well as the requirement of mandatory bids), defensive measures for that purpose are unnecessary.

c) Stakeholders' interests

Apart from the shareholders, the stakeholders of a company, which are usually defined as including the employees, creditors and suppliers of a company as well as the public, might be affected by a hostile takeover. Employees might especially be concerned, since a hostile takeover often leads to layoffs due to rationalization, as well as the renegotiations of contracts[56]. Consequently, it should be thought about whether the stakeholders' interests deserve special attention in the situation of a hostile takeover as well.

While every country agrees that the shareholders' interests should play an important, if not the only, role in the management's decision, there remain differences about the treatment of stakeholders' interests.

Anglo-American countries, such as the US, Canada and the UK, tend to pursue the shareholder-value approach, which means that the management's priority is to ensure that the shareholders get the highest value for their investment[57]. In most European countries, particularly in Germany, stakeholders play a much more important role, and therefore their interests usually have to be considered in the decision-making process of the management as well. However, this classification is no longer as clear as it used to be, as the different perceptions of the stakeholders' role seem to shift.

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[55] J.N. Gordon, "Poison Pills and the European Case" (2000) 54 U. Miami L. Rev. 839 at 841.
[56] P. S. Sudarsanam, *The Essence of Mergers and Acquisitions* (London: Prentice Hall, 1995) at 7.
[57] Jenkinson & Mayer, *supra* note 29 at 18.

Germany, in the course of globalization, the growth of capital markets and the rising importance of shares as an investment possibility, increasingly follows the shareholder-value concept. Nevertheless, in the discussions on the subject and the drafting of the final regulatory statute, stakeholder interests still played an important role.

In the US, the long predominant shareholder value approach[58] has made room for a policy that also considers stakeholder interests especially in the context of hostile takeovers[59]. This policy is embodied in so-called "non-shareholder constituency statutes" as part of the takeover regulations of the states, which allow the management to take into account the stakeholder interests when being faced with a takeover offer[60]. The courts have also confirmed the importance of the consideration of stakeholder interests in decisions regarding the behaviour of the management in hostile takeovers[61]. Also in the UK, case law and statutory provisions have evolved with respect to the interests of employees and creditors.

This development goes along with a change in the perception of the role of a company in Anglo-American countries. Traditionally, the view prevailed that the only purpose of a company was to ensure shareholder wealth maximization[62]. This derives, among others, from an understanding of the company as a nexus of contracts[63]. Now, the corporation is increasingly perceived as a community of interests having a social responsibility, including a regard for other interests than those of the shareholders[64]. Nevertheless, the shareholder primacy norm prevails[65].

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[58] See *Dodge v. Ford Motor Co*, [1919] 170 N.W. 668 (Mich.) at 684: "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end".

[59] E. W. Orts, "Beyond Shareholders: Interpreting Corporate Constituency Statutes" (1992) 61 Geo. Wash. L. Rev. 14 at 16.

[60] M.G. Robilotti, "Codetermination, Stakeholder Rights, and Hostile Takeovers: A Reevaluation of the Evidence from Abroad" (1997) 38 Harvard L. Rev. 536 at 537, 539.

[61] *Unocal Corp. v. Mesa Petroleum Co.* (Del. 1985), 493 A.2d 946 [hereinafter *Unocal*] at 955; *Paramount Communications, Inc. v. Time, Inc.* (Del. 1989), 571 A.2d 1140 [hereinafter *Paramount v. Time*] at 1153.

[62] R.O. Kuras, „Corporate Social Responsibility: A Canada – U.S. Comparative Analysis" (2002) 28 Man. L. J. 303 at 303.

[63] *Ibid.* at 305.

[64] *Ibid.* at 305f.

In the classic economic model of the principal-agent conflict, stakeholder interests have not been included so far. The consequence of doing so would be to render the supervision of the management more complicated, since it is hard to find criteria for how much consideration each party should get[66]. Furthermore, the costs of monitoring the management would increase[67]. From an economic perspective the shareholders bear the financial risks of a company, which makes their interests predominant[68]. On the other hand, stakeholders are exposed to certain risks, whereas the shareholders can minimize their own (e.g. by holding a wide portfolio of shares and the possibility to sell them at any time). This might lead to a consideration of stakeholder interests under the economic aspect[69].

To achieve consistent regulation, it is important to align both the economic and legal views on this point, depending on every country's understanding of the treatment of stakeholders' interests. This is especially important in the hostile takeover context, since it can substantially affect all participants in a company.

II. The purposes of hostile takeovers

Here it will be outlined to what extent hostile takeovers have generally had positive effects on the economy and companies.

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[65] *Ibid.* at 312, 319.
[66] A.W. Dimke & K.J. Heiser, "Neutralitätspflicht, Übernahmegesetz und Richtlinienvorschlag 2000" (2001) NZG 241 at 248.
[67] G.T. Wiese & D. Demisch, „Unternehmensführung bei feindlichen Übernahmeangeboten" (2001) DB 849 at 850.
[68] *Ibid.*
[69] M. M. Blair, "Whose Interests Should Corporations Serve?" in M. B. E. Clarkson, *The Corporation and Its Stakeholders: Classic and Contemporary Readings* (Toronto: University of Toronto Press, 1998) 47 at 62.

1. Hostile takeovers as an instrument of corporate control

a) The development of directorial control

In the US in the 1930s, it was argued that the power of the management in publicly held corporations grew close to autonomy[70]. This was due to the widespread distribution of share capital, which led to a "collective action" phenomenon, meaning that the costs of coordinating a shareholder's action with other shareholders outweighed its benefits[71]. The consequence of this is that especially minor, financially oriented shareholders would rather sell their shares if they are dissatisfied than take costly actions to effectuate changes within the company. This behaviour is called the "wall street walk" or "wall street rule"[72]. This result is also caused by the so-called "free-rider problem": if just one or a few shareholders take measures against the existing management, they have to spend money and bear the risk while they at the same time gratuitously create value for others[73], eventually preventing them from taking such costly actions. Even large and institutional investors for whom it is, in contrast to the smaller shareholders, easier to influence the management, would prefer to buy shares in another company if one of them becomes unprofitable, since they usually hold a wide portfolio of shares in different companies. Additional means of control thus had to be introduced.

These phenomena are not restricted to the US, but appear in many countries and in companies with widely distributed shareholders. One crucial aspect having a big influence on control mechanisms is the participation of financial intermediaries, like banks[74]. Whereas the influence of banks as shareholders is very fragmented and restricted in the US[75], they still play an important role in Germany, which, as with any other concentrated ownership, diminishes the influence of the respective management. In any

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[70] A.A. Berle & G.C. Means, *The Modern Corporation and Private Property* (Macmillan Co.: New York, 1933).
[71] C. Escher-Weingart, „Corporate Governance Strukturen – ein deutsch-U.S.-amerikanischer Rechtsvergleich" (2000) ZvglRWiss 387 at 395-396.
[72] Klein & Coffee, *supra* note 38 at 164.
[73] *Ibid.*
[74] M.J. Roe, "Some Differences in Corporate Structure in Germany, Japan, and the United States" (1993) 102 Yale L. J. 1927 at 1929-1930 [hereinafter "Some Differences"].

case, even if national characteristics like this caused the development of different concrete control mechanisms, a general classification of control systems can be observed in, among others, North American and Western European countries. They cannot be wholly explained by the economic model, however; historical, cultural and political aspects play an important role [76].

b) Classification of control systems

Hostile takeovers can act as a monitoring device to ensure that the directors do not pursue their own interests in managing the company, as was mentioned above[77]. To establish the need and the importance of that role as a means of control, the different possible levels of control, including their significance and efficiency, will be outlined first.

(1) Internal control

There are internal control systems implemented through corporate law and that form part of the corporate governance structure. Corporate governance, initially a term developed in the framework of economic theory[78], regulates, among others, the organization of a company and the relationships among the parties involved in a corporation, such as management, shareholders and stakeholders[79]. It can be divided into internal and external corporate governance, the former including the control mechanisms within the company, and the latter describing the participation of external factors, such as market forces[80]. In the context of internal corporate governance, corporate law provides institutional arrangements to minimize the opportunistic behaviour of the parties involved in a corporation[81].

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[75] „Some Differences", *supra* note 74 at 1935.
[76] *Ibid.* at 1997.
[77] See C.I.1.
[78] Escher-Weingart, *supra* note 71 at 387.
[79] K.J. Hopt, „Gemeinsame Grundsätze der Corporate Governance in Europa?" (2000) ZGR 779 at 782 [hereinafter „Corporate Governance"].
[80] „Corporate Governance", *supra* note 79 at 782.
[81] Escher-Weingart, *supra* note 71 at 387-388.

In different countries there are different internal control mechanisms established to supervise the management.

In the US, for example, the management of a company is divided into the board of directors and the executive board, with the board of directors partly monitoring the executive board. However, both organs are involved in the management of the company, and some of the executives are also on the board. Particularly in English speaking countries there exists no clear division between control and management. Companies therefore started to employ independent directors, often nominated by a special committee to secure their neutrality, as well as to use auditors[82].

In Germany, internal control is provided by the two-tier management system in public stock corporations ("AG"), with a supervisory board monitoring the actions of the executive board. Any kind of internal control by a supervisory body different from the management itself, however, raises the problem that the controlling organ has to be efficiently controlled itself[83]. If the supervisory board is not entirely independent, it might be involved in the conflict of interests, which does not make it a suitable additional controlling device.

(2) External control via the market of corporate control

In the so-called "market for corporate control"[84], weak participants - in this case the directors - are, if they do not perform sufficiently, likely to be replaced. This occurs if directors do not lead their company in an efficient way[85]. Hostile takeovers play a crucial role in that control mechanism as they constitute a means to transfer control of

[82] Klein & Coffee, *supra* note 38 at 160.
[83] „Corporate Control", *supra* note 17 at 701.
[84] H.G. Manne, "Mergers and the Market for Corporate Control" (1965) 73 J. Pol. Econ. 110.
[85] C. Kirchner, „Neutralitäts- und Stillhaltepflicht des Vorstands der Zielgesellschaft im Übernahmerecht" (1999) AG 481 at 481 [hereinafter „Pflicht des Vorstands"].

unsuccessful companies to new shareholders providing more efficient management[86] and valuing company assets to a higher extent[87].

A company is likely to become a takeover target if its share price falls under its potential value, which is often an indication of an inefficient management[88]. Usually, if a bid succeeds and the bidder gains control over the company, he will replace the incumbent management to pursue its own business strategy and raise the efficiency of the company[89]. In strategic takeovers, this is normally achieved by restructuring the company, often combined with large asset disposals.

However, as a British study in the mid-80s showed, 90 per cent of the corporations which remained independent after a rejected bid still underwent significant restructuring[90]. This shows that even if a bid is rejected, the mere possibility of being taken over gives the management of the target company the incentive to improve efficiency. Likewise, shareholders of companies that have never been the target of a hostile bid profit from the deterrent effects of hostile takeovers[91].

Other market forces controlling managerial efficiency are the product and services market, which determines the economic success of a company, as well as the market for managerial services[92].

(3) Shareholder activism

Since the 1990s, large institutional investors have become more significant, especially in the US. If an investor already holds a large enough stake in a company, the collective action phenomenon as well as the free rider problem might not be as relevant, since they

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[86] Jenkinson & Mayer, *supra* note 29 at 13.
[87] R.J. Gilson, „The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment" (1992) 61 Fordham L. Rev. 161 at 164.
[88] Escher-Weingart, *supra* note 71 at 389.
[89] S. Harbarth, „Abwehr feindlicher Übernahmen in den USA" (2001) 100 ZVglRWiss 275 at 277.
[90] Jenkinson & Mayer, *supra* note 29 at 12.
[91] Coffee, *supra* note 45 at 1192.
[92] "The Proper Role", *supra* note 21 at 1196-1197.

can execute an efficient monitoring function themselves. They are able to influence the management either by voting at the shareholders' meetings ("proxy votes"), as well as by negotiating directly with the management[93].

There are, however, still differences between the various countries as to the degree of influence of large and institutional shareholders in the control of management. This is due to structural characteristics concerning the extent to which certain companies can own significant stakes in other companies. Some countries, such as the US, are very restrictive in some areas, while in other countries, such as Germany, banks and insurance companies have long been involved in large cross-shareholdings, especially among the biggest companies.

c) The necessity and significance of hostile takeovers as a control instrument

After having assessed the different possibilities of monitoring management, the question remains whether a means of control via the market of corporate control is really necessary. Evidence shows that internal control mechanisms and shareholder activism might not be enough.

It has been argued that market forces such as hostile takeovers can reduce agency costs[94], which are the costs deriving from the conflict of interests in agency relationships[95]. These costs consist, among others, of the monitoring costs which have to be born by the shareholders to supervise the management[96]. These monitoring costs can be minimized by the possibility of replacing management through a hostile takeover without the need of its approval, unlike in a friendly merger[97]. In this way, an inefficient management can be

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[93] Escher-Weingart, *supra* note 71 at 389-390.
[94] R. Romano, „A Guide to Takeovers: Theory, Evidence and Regulation" (1992) 9 Yale Journal on Regulation 119 at 129.
[95] Jensen & Meckling, *supra* note 36 at 308.
[96] *Ibid.*
[97] Romano, *supra* note 94 at 129; even though the eventual replacement of the management might sometimes be quite difficult, for example in the case of staggered boards in the US, see *infra* note 269, or in Germany, where the supervisory board appoints and removes the directors, see F.II.1.

changed and the incumbent management has an incentive to pursue the interests of the shareholders.

If takeovers are hindered or made more costly due to the use of defensive measures, agency costs will increase due to the decrease of hostile takeovers and the reduction of control via the market [98].

On the other hand, arguments have been raised against the idea that hostile takeovers act as a means of control. These include the occurrence of takeover waves, especially among certain industries, which contradict the functioning of takeovers as a constant monitoring device. There is also the volatility and sometimes inefficiency of the stock market, which does not give a reliable indication of the state of a company[99]. Critics additionally point out the phenomenon that efficiently operating companies are sometimes taken over[100]. In many cases the management of a company is retained after a takeover, and some bidders especially focus on taking over a strong and capable management [101]. On the other hand, sometimes companies which are seriously distressed are not taken over, as they are too unattractive or constitute too high of a risk for their acquirers that does not justify the takeover premiums[102].

These factors notwithstanding, hostile takeovers still have a considerable disciplinary effect on weak managers[103], although it is true that the control via the market should not exclusively be relied upon. This is partly because of the criticisms cited above, especially since in certain times discipline via the market might be weaker and therefore might not always be particularly efficient, and also due to the importance of other control mechanisms.

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[98] „The Proper Role", *supra* note 21 at 1179.
[99] Klein & Coffee, *supra* note 38 at 174-175.
[100] Heiser, *supra* note 50 at 72.
[101] Coffee, *supra* note 45 at 1212.
[102] *Ibid.* at 1204.
[103] See also Klein & Coffee, *supra* note 38 at 175.

On the one hand, it does not necessarily have to be the last resort, as it has been proposed[104], especially since the threat alone already has a disciplining effect, without the need for the actual happening of a hostile takeover. Also, it cannot be maintained that other strong monitoring systems, such as the one applied in Germany via the dominant role of banks as major shareholders, could serve as an equivalent substitute for external control[105]. One of the reasons is that banks, which are often creditors of the company at the same time, pursue not only shareholders' goals, but also their special interests as creditors that often outweigh their interests as shareholders[106]. They therefore cannot act as an entirely independent monitoring device. Additionally, their interference usually takes place by exercising influence in the general course of business rather than effectuating essential structural changes[107]. Last but not least, the current trend to the diminishment of large shareholdings, including cross-shareholdings, due to economic changes shows that they are not a permanent phenomenon which can be relied upon.

On the other hand, market forces should not provide the primary disciplinary measure either since the importance of other means of control, especially the ones provided by corporate law, should not be underestimated[108]. The ideal situation is a balanced cooperation of all controlling elements, since it not only multiplies the extent of control of the management, but also allows the different monitoring organs to control each other[109]. The market of corporate control can therefore be seen as an external instrument supervising and supplementing the internal control system of a corporation[110].

2. Internationalization and realization of synergies

Another function of hostile takeovers is to stimulate merger activity, and therefore to give companies the possibility to internationalize their business and to enhance value and

[104] Coffee, *supra* note 45 at 1153.
[105] C. Bergstrom, P. Hogfeldt, J.R. Macey & P. Samuelsson, "The Regulation of Corporate Acquisitions: A Law and Economics Analysis of European Proposals for Reform" (1995) 1995 Colum. Bus. L. Rev. 495 at 502.
[106] *Ibid.* at 504.
[107] *Ibid.* at 503.
[108] Coffee, *supra* note 45 at 1199.
[109] Escher-Weingart, *supra* note 71 at 403.

efficiency by realizing economies of scale, economies of scope as well as synergies[111], even if the management of one company initially opposes it. These positive effects of "forced" mergers, however, only take place in successful mergers, where real economies and synergies can be gained and integration procedures are carefully implemented.

III. Critics of and costs resulting from hostile takeovers

While hostile takeovers as described above - even if subject to some criticisms - are generally seen as creating wealth for the shareholders[112], the threat and possibility of them might create negative effects and costs as well.

1. Short-termism

Concerns have been raised that the threat of hostile takeovers might cause management to give up long-term planning and focus on short-term opportunities instead, leading to a phenomenon called "short-termism"[113]. Instead of engaging in long-term business strategies by investing the annual gains of the company, such as in R&D projects, the management rather relies on short-term strategies, such as paying out large dividends, in order to minimize the chance of being taken over by a hostile bidder[114]. To what extent this phenomenon really exists is controversial due to a lack of studies. However, partly due to speculative activities and the growing number of investment funds, which attract customers by presenting short-term but visible success of their investments, short-termism can increasingly be observed[115].

On the other hand, the threat of hostile takeovers does not necessarily prevent directors from implementing long-term business strategies. If such a strategy is efficient and

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[110] M.C. Jensen, *A Theory of the Firm* (Cambridge, Mass.: Harvard University Press, 2000) at 148f.
[111] Jenkinson & Mayer, *supra* note 29 at 13.
[112] Coffee, *supra* note 45 at 1173.
[113] Jenkinson & Mayer, *supra* note 29 at 14.
[114] *Ibid.*
[115] Heiser, *supra* note 50 at 71.

successful, it will be rewarded by higher share prices, discouraging hostile takeover efforts[116].

2. Inefficient growth maximization

The "Managerialists", another American school of economists, argued that, among other things, the threat of hostile takeovers might cause directors to pursue a strategy of growth maximization instead of profit maximization, as a larger size might prevent a company from becoming an easy takeover target[117]. This phenomenon of "Empire Building"[118] is accompanied by a tendency to re-invest earnings in the company, rather than paying out dividends to the shareholders, which leads to inefficient growth and an unprofitable use of funds[119]. Also, bidders might be motivated to take over other companies in order to enhance management compensation, prestige, market power and presence[120]. However, this phenomenon, which was first described in the 1960s, seems to appear less, especially as the tendency towards corporate restructuring grows[121]. Additionally, antitrust laws often place limits on the size of a company[122]. Finally, the use of empire building as a means to prevent hostile takeovers contradicts the short-termism model, which seems to be more likely to occur as a defence mechanism. This is supported by the fact that inefficient large companies also constitute an easy target for a hostile takeover, indicating that directors should prevent unprofitable growth strategies[123]. Still, empire building continues to occur, although other motives than the prevention of hostile takeovers seem to play a more important role[124].

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[116] "The Proper Role", *supra* note 21 at 1184.
[117] See Klein & Coffee, *supra* note 38 at 161.
[118] Coffee, *supra* note 45 at 1167.
[119] Klein & Coffee, *supra* note 38 at 162.
[120] Coffee, *supra* note 45 at 1167f.
[121] Klein & Coffee, *supra* note 38 at 162.
[122] Romano, *supra* note 94 at 142.
[123] See Klein & Coffee, *supra* note 38 at 162.
[124] „Endet die fünfte Welle auf dem Markt für Unternehmensübernahmen in einer neuen Rezession?" *Frankfurter Allgemeine Zeitung* (4/10/2000).

Another, in some points similar, phenomenon is the diversification of corporate activities by directors engaging in mergers in order to secure their wealth and position[125]. This enlargement of the portfolio is not in the interests of the shareholders, since they could obtain this result much more easily by buying shares in a different company, and in this case their company might even have to pay a premium for the acquisition of another company[126]. However, this behaviour does not seem to happen very often in practice, partly due to the reasons cited above.

3. Rising pressure and risk preference

It has been argued that a high frequency of hostile takeovers and a low level of takeover premiums might cause both the bidder as well as the target management to undertake poorly reflected actions involving high risk. On the bidder's side, the possibility to take over other companies at a relatively low price without major difficulties might result into inefficient transactions. On the other hand, the enhanced threat of being taken over might be an incentive to the management of the target company to make risky and overhasty decisions or to take on increased leverage, which could also be used for a leveraged buy-out[127]. Recent observations confirm that this is in fact often the case[128].

4. Higher contracting costs

Depending on the system of "contractual governance[129]", implicit contracts based upon trust between the parties play an important role in some countries, especially Germany and Japan. If the employees and suppliers feel that they cannot rely on the new owners of the company and their chosen management to know and respect the unwritten agreements and practices between the former parties, detailed explicit contracts and dispute resolution in front of the courts, which is common now in the US, will be asked for in the future.

[125] Romano, *supra* note 94 at 147.
[126] *Ibid.* at 147f.
[127] Coffee, *supra* note 45 at 1158.
[128] „Endet die fünfte Welle auf dem Markt für Unternehmensübernahmen in einer neuen Rezession?" *Frankfurter Allgemeine Zeitung* (4/10/2000), citing the example of the failed merger of Deutsche Bank and Dresdner Bank, which was partly motivated by the merger and takeover fever among banks at that time.

This, apart from raising the contracting costs, could have a substantial impact on the business practices of a country as a whole[130].

On the other hand, the breach of implicit contracts is not a necessary consequence of a hostile takeover. Future shareholders can also profit from long-term relationships with employees and suppliers which have been with the company for some time[131]. It is not in the interest of an acquirer to terminate contracts which have proven to be efficient and will be so in the future, especially since the bidder paid for them. The reputation of the company being a trustworthy contracting partner is also a consideration[132]. Often a hostile takeover also causes, due to a rise in efficiency, higher salaries and productivity, as well[133].

Another aspect is that the costs of getting and keeping superior management will increase, especially for companies which are likely to be taken over[134]. This makes it harder for a company to enhance efficiency via the market for executive services, so that a large degree of external control through a high frequency of takeovers might be counterproductive to corrections which could be taken in an earlier stage[135]. In the end, however, it is more likely that a change of management will occur with new shareholders due to circumstances such as a close relationship between the old shareholders and the incumbent management and the fact that such a drastic measure usually requires a particular incident preceding it.

IV. Conclusion

Without doubt, there are two sides to hostile takeovers, and arguments speaking for and against them having positive effects in an economy. This chapter treated only the theoretical reasoning of economists and lawyers. To verify whether their conclusions

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[129] See Jenkinson & Mayer, *supra* note 29 at 16.
[130] Jenkinson & Mayer, *supra* note 29 at 15ff.
[131] Romano, *supra* note 94 at 139.
[132] Gilson, *supra* note 87 at 191.
[133] Romano, *supra* note 94 at 141.
[134] Coffee, *supra* note 45 at 1159.

occur in reality, which of two contradicting theories might prove to be the actual case and whether other irrational factors play a role in economic practice, empirical evidence is needed. The results gained from empirical evidence, however, usually only apply to a specific country and cannot be transferred that easily to other economic systems. Also, many studies examine the success or the failure of subsequent business combinations, whereas they do not consider the effects of hostile takeovers as a disciplining device that can raise the efficiency of a company without a hostile takeover actually taking place. The different theories, on the other hand, while not providing a complete explanation themselves, can be used on a broader basis to determine the factors to be considered in the regulation process. Due to these reasons and a general lack of comprehensive empirical evidence, this work is predominantly concerned with the theory and its application for future regulation.

The analysis of the theoretical arguments above results in the conclusion that an economy and its companies benefit considerably from hostile takeovers. To meet the inherent risks and costs and to protect the interests of the parties concerned, additional protective mechanisms could be considered. A complete elimination of all negative effects surely cannot be achieved. Nevertheless, the benefits clearly outweigh the costs, and the absence of hostile takeovers would bring far more disadvantages to the economy than hostile takeovers actually do. The general policy, therefore, should not be to support defensive measures in order to hinder takeover activity, but rather, to take a neutral stance.

The conclusion drawn from parts II and III of this chapter does not contradict, but rather compliments the findings in part I of this chapter, which identifies the affected interests in a hostile takeover, and assesses to what extent they should be considered. The interests of the shareholders in general prevail, even if the interests of the stakeholders might be taken into account. An approach which leaves to the shareholders the freedom of deciding on the use of defensive measures generally meets their interests best, even if they often have opposing interests, caused by the existence of various groups of shareholders with different objectives concerning their investment in a specific company. Considerations

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[135] Coffee, *supra* note 45 at 1159.

which might favour the use of defensive measures for shareholders and stakeholders can often be met by additional protection, by way of the offer regulation as well as in separate legislation concerning the interests of other parties, such as the employees. In leaving the final decision to the shareholders, however, the consequences of their actions impinge not only on the instant transaction, but also the economy in general and these external factors should not be left out of the equation. The detailed drafting of such a regulation, and how it would best meet the interests of the shareholders and the overall economy in its influence on hostile takeover activity, will be discussed in the following chapter.

D. WAYS TO INFLUENCE AND REGULATE HOSTILE TAKEOVER ACTIVITY AND DEFENCE MECHANISMS

Before identifying and evaluating the ways in which hostile takeover activity and the use of defensive measures can be regulated, one must determine which factors can affect the occurrence and success of hostile takeovers, and the role that the regulation of defensive measures plays in that context. Subsequently, one must assess which of these factors can actually be directly or indirectly influenced by a regulating authority, and what the preferable method of intervention is. It will be shown that the explicit regulation of defensive measures is not the only way in which to influence hostile takeovers, but is in fact one of the most efficient, and therefore should be our starting point. After that, the precise form of regulation can be considered.

I. Different factors affecting hostile takeover activity

1. General corporate law

The legal treatment of hostile takeovers and possible defensive measures can be fit into the existing legal framework, especially corporate law. The extent to which defensive measures are allowed, which finally influences hostile takeover activity, depends on the definition of the duties of the management and the shareholders' rights, as well as on the role which the interests of the stakeholders play. Corporate law also determines how much freedom companies have in the drafting of their constitution and in creating or restricting certain shareholders' rights, and therefore in implementing defensive measures.

Other than imposing rules which affect the possible use of defensive measures, corporate law can influence the success of hostile takeovers or make the subsequent gain of control of the company and its management more difficult by creating or restricting structural and technical barriers.

2. Special regulation of hostile takeovers

Hostile takeover activity can be directly influenced by establishing special statutes or jurisdiction, which usually, as the more applicable law, will super-cede the existing law in the given area of regulation. This might also be achieved by the establishment of administrative rules or codes of conduct, as long as they are linked with a mechanism that ensures compliance. The regulation can extend or restrict the powers of the management provided by corporate law.

3. The economic structure

The particular economic structure of a country can either favour hostile takeovers, or make them more difficult. Political, social and cultural factors play a role, as in particular does the distribution of wealth, the role of the banks and of institutional investors[136], as well as the incidence of cross-shareholdings among large corporations.

Another crucial factor is the extent to which companies are publicly quoted. Private and state ownership are substantial barriers to hostile takeovers. Younger companies influence that number in the way they raise capital - either by bank financing or by going public[137].

4. Economic influences

The overall economic situation influences the business strategies of companies, their choice of expansion or rationalization, as well as their ability to raise capital. It also determines the extent to which companies expose themselves by publicly listing their shares on the stock exchange. In the past, there have been periods in which takeover activity was particularly prevalent due to economic circumstances.

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[136] Jenkinson & Mayer, *supra* note 29 at 19.
[137] *Ibid.* at 19-20.

II. Methods of regulating defensive measures in hostile takeovers

As outlined above, there are several factors which can affect hostile takeover activity. They can be classified into legal or other regulations and economic conditions. The economic structure and situation cannot be directly changed by the legislature or other regulating bodies, but they develop due to a combination of different factors. These aspects can partly be regulated, but usually only indirectly influence the incidence of hostile takeovers, since they merely represent a minority among a number of other factors. Consequently, the most efficient way to influence hostile takeover activity is by direct regulation, which includes the use of defensive measures, and which can either be explicit or implied in other, more general rules.

First, it will be addressed which is the most favourable form of takeover regulation. Then, the best treatment of defensive measures in such a regulation will be discussed.

1. The form of hostile takeover regulation

a) The need for an explicit regulation

As stated above[138], the proper behaviour of the management in a hostile takeover does not necessarily have to be defined by explicit regulation. The according interpretation of existing regulations and principles of corporate law in the context of hostile takeovers can also sufficiently define the limits of managerial authority. Amendments to the current law can either be made by changing the rules or their interpretation.

This, however, carries the danger that the present rules cannot be easily adapted to the special situation of a hostile takeover, and that unwanted regulative gaps occur. Also, the often very general rules might leave room to various ways of interpretation, and therefore lead to legal insecurity. On the other hand, an explicit regulation of hostile takeovers and defensive measures creates clear conditions and also gives the opportunity to modify them directly if necessary.

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[138] See D.I.1.

b) The legal character

(1) Binding legislation

The clear advantage of an explicit binding legislation in form of a statute is the legal certainty it provides. Also, the parties concerned can always rely upon the enforcement of their rights in front of the courts, if it is necessary.

One of the disadvantages is the inherent lack of flexibility[139], since a legislative process is usually very slow and time consuming. Especially in the field of hostile takeovers, where economic and technological changes occur rapidly, and also in the context of harmonization and internationalization, the rules should remain flexible in order to be able to match the varying circumstances. Another argument against binding legislation is that more litigation, which can require a great deal of time and expenses, might occur as a result of the lack of other bodies entitled to decide in conflict situations.

(2) Self-regulation

Like binding legislation, self-regulation would normally also involve the creation of a set of rules governing hostile takeovers. The basic difference lies in the enacting authorities, and in the dispute resolution process. Rules adopted by authorities other than the legislature are not legally enforceable.

The advantages of self-regulation without legal sanctions as opposed to a binding legal regulation is, first of all, its flexibility. The process to effectuate the necessary amendments will be much less complex and time consuming than a proper legislative procedure[140]. Additionally, if the affected parties are involved in the regulation process, such as representatives of companies, investors, banks and the stock markets, the result is more likely to match their needs and therefore to be accepted by them[141].

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[139] Jenkinson & Mayer, *supra* note 29 at 23.

[140] T. Baums, *Notwendigkeit und Grundzüge einer gesetzlichen Übernahmeregelung*, Arbeitspapier Nr. 79 (Osnabrück: Universität Osnabrück, 2000) [hereinafter „Notwendigkeit"] at 3.

[141] "Notwendigkeit", *supra* note 140 at 3.

On the other hand, it has to be ensured that even if there are no legal sanctions, practical sanctions have to be expected by companies which do not act in accordance with such a regulation[142]. Otherwise, as was shown by the non-binding German "Übernahmekodex" from 1995, which was accepted by many German DAX-companies, but not all of them, it will just remain a mere recommendation, which no one is obliged to follow. One positive example is the City Code on Takeovers and Mergers, which is generally accepted by the companies, since they know that they have to face practical consequences, which might seriously affect their ability to do business if they do not act in accordance with the Code[143].

The self-regulation has to be well organized and supervised to provide an alternative to legislation and its enforcement via the courts. The decisions of the administrative body should be able to be revised if they are objected to, since otherwise it would have the exclusive power in that area. To avoid that, there ought to remain the possibility of a review of the decisions by the courts as a last resort, which gives the participants the security of a binding legal decision. If the administrative body had some discretion in how to judge certain cases, however, the courts should not put their opinion in place of that of the administrative body, since the latter will possess expert knowledge. The courts should consequently just revise whether the rules have been followed by the administrators, and whether they used their discretion in an appropriate and fair way[144].

In order to enable the establishment of self-regulation in certain areas of law, it has to be ensured that the competence to regulate the subject is not entirely assigned to the legislative authorities, and that no conflicts appear in relation to legal regulations. This difficulty will be treated extensively below[145].

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[142] *Ibid.*
[143] *Ibid.* at 20.
[144] This is basically the way it works in the UK, see E.II.2.c)(1).
[145] See D.II.3.

(3) Judicial review

Agency relationships are governed by fiduciary principles, which are laid down in corporate law. Fiduciary principles impose a standard of conduct on the management, especially in situations of conflicts of interest[146], to make sure that the management's actions are taken in the interests of the company and the shareholders (the definition of the company interests can differ, but often includes the stakeholders as well). In determining whether the management has acted appropriately, the courts do not put their own judgement in place of the one of the directors, since they lack the necessary expertise[147], but merely assess whether the management had regard to certain principles in making its decision. When the compliance of the management's behaviour with these fiduciary principles can be scrutinized and sanctioned by the courts, like in the US, this subsequent control can constitute an alternative to direct monitoring. Due to the indistinct nature of fiduciary principles, however, it might be hard for the management to predict in advance whether their behaviour meets the requirements or not.

Another important aspect is whether the burden of proof that the directors have met certain standards lies on the plaintiff or on the directors. Due to the difficulties of the plaintiff in having an insight into the activity of the management, and to the fact that the directors are in a conflict of interest[148], which generally requires enhanced scrutiny, it would be preferable to put the burden of proof on the management.

A possibility for the management to avoid the danger of being held liable after the event might be to get the use of defensive measures approved by experts, such as lawyers, in advance[149]. This solution is, however, costly and time-consuming, and does still not eliminate every uncertainty, especially in borderline cases which have not been decided

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[146] "Corporate Control", *supra* note 17 at 702.

[147] B. Welling, *Corporate Law in Canada, The Governing Principles*, 2nd ed. (Toronto: Butterworths, 1991) at 346f.

[148] R. L. Simmonds, „Changing the Regulation of Defence Tactics in Canada" in *Meredith Memorial Lectures, Faculty of Law, McGill University, Acquisitions and Takeovers* (Cowansville, Québec: Les Editions Yvon Blais Inc., 1987) 157 at 165.

[149] „Pflicht des Vorstands", *supra* note 85 at 490.

by the courts before. In addition, jurisdiction can change easily in the future as opposed to statutes, which gives it more flexibility, but also less predictability[150].

(4) Conclusion

To achieve the flexibility and speed of self-regulation, the possibility to obtain official, legally binding decisions, as well as the security of rules which are formulated in advance, the best solution would be to combine self-regulation of the administrative bodies, which establish certain rules governing the takeover process, with court supervision. The concerned parties should participate or at least advise in the rule setting process together with the administrative bodies, which should also ensure compliance with these rules and set up a dispute resolution process, whereas the courts should step in as a last authority if the self-regulatory process does not lead to results satisfying all participants[151].

2. The content of the regulation concerning defensive measures

After having established the form of the regulation, which authority should be responsible and how resulting disputes should be resolved, the regulations themselves must be considered. Before assessing the authority of the management to take defensive measures in the face of an attempted hostile takeover, one must decide what exactly should constitute a defensive measures in the sense of the regulation, and where the limits have to be drawn.

a) The definition of defensive measures in the regulatory context

An action taken by the target management constitutes a defensive measure if it is aimed at defeating a hostile action, and if it is capable of doing so.

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[150]See L. A. Bebchuk & A. Ferrell, "Federal and Corporate Law: The Race to Protect Managers from Takeovers" (1999) 99 Colum. L. Rev. 1168 [hereinafter "The Race"] at1172.
[151] "Notwendigkeit", *supra* note 140 at 5f.

Sometimes, however, it is hard to distinguish whether an action is meant to be a focused defensive measure in the sense of the regulation, or whether it is just the use of a business opportunity or part of a strategy which was started before the offer occurred, and which ultimately has the same effect as a defensive measure. On the one hand, it is generally accepted that management should not be prevented from doing ordinary business or pursuing certain strategies[152]. On the other hand, the allowance of certain actions in particular circumstances should not lead to an excuse for the management to take defensive measures which are not permitted or which are restricted[153].

One criterion to distinguish defensive measures from other measures is certainly the timing of the action. If the preparation of an action took place before the offer, it is an indication that it is not meant as a defensive measure[154], unless it constitutes an effective preventive mechanism against any hostile offer in the future. A sign that this is not the case is when the action is taken in pursuance of a concrete strategy which has been published in advance. Otherwise, it is harder to distinguish. One way to solve this problem is to place the burden of justification on the management in respect of the purpose of an action[155]. Another possibility is to give firm indications as to what kind of action or arrangement belongs to the ordinary course of business[156], and therefore give instructions as to what is usually seen as a defensive measure.

b) The power of directors to take defensive measures

There are a number of ways of regulating the management's ability to use defensive measures[157] set out below, which range from one extreme, which is strict passivity, to the other, where directors are given greater opportunities to defend against a hostile takeover than they had before.

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[152] „Verhaltenspflichten", *supra* note 19 at 1391.
[153] "The Proper Role", *supra* note 21 at 1202-1203.
[154] *Ibid.* at 1203.
[155] *Ibid.* at 1204.
[156] See e.g. note 6 on Rule 21.1 of the City Code on Takeovers and Mergers.

(1) Strict passivity

Strict passivity of the management concerning actions which are capable of amounting to defensive measures seems to be the most efficient way to avoid the principal-agent conflict and to ensure that the management does not interfere with the shareholders' interests. The complete passivity of the management can, however, cause several problems.

The question is whether the shareholders will then have sufficient authority or competence to make the necessary decisions instead. That might lead to the consequence that even if the shareholders are willing to take defensive measures, they could not practically pursue their interests on their own[158]. Even if shareholders are able to act for themselves, such a regulation would practically dissolve the agency relationship in the situation of a hostile takeover. That would consequently eliminate the inherent conflict of interest, but also the advantages of and reasons for which the agency relationship was entered into in the first place – the benefit of the expertise and professionalism of the management, including its in-depth information about the company affairs[159]. Due to a lack of practicability, this is not a satisfactory model.

(2) Neutrality with the possibility of authorization by the shareholders for a defensive measure

Another solution would be that the management still generally acts for the shareholders in the event of a hostile takeover, but that it is not permitted to take any actions which could hinder or prevent the bid from succeeding, unless it is explicitly authorized by the shareholders[160]. In this way, the problem of authority and competence would be

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[157] A similar, but in some points different classification was made by Kirchner, „Pflicht des Vorstands", *supra* note 85 at 485.
[158] Wiese & Demisch, *supra* note 67 at 850.
[159] *Ibid.*
[160] The expression „neutrality" can be misunderstood as complete passivity of the management, although it is usually meant in the sense that the management must not frustrate an offer with the consequence that the shareholders are deprived of the possibility to accept it, as outlined here. See T. Drygala, „Die Neue Deutsche Übernahmeskepsis und Ihre Auswirkungen auf die Vorstandspflichten nach §33 WpÜG" (2001) ZIP 1861 at 1863.

eliminated, since the shareholders get the power to decide when it comes to questions within their area of competence, and the management the execution power. The agent still acts on behalf of the principals, but with a limited freedom of choice, so that the usually enhanced principal-agent conflict in the case of a hostile takeover can be obviated.

This ability of the shareholders to decide about the actual use of defensive measures after an offer has been made is important since even if they have the intention of eventually selling their shares, they might be interested in achieving a higher premium and/or in initiating an auction. An auction usually results in a better price, but also in a more interested or suitable bidder, which might in the end be advantageous for the shareholders who decide to remain with the company. Defensive measures, which delay the bidding processes and give the management additional means to negotiate, can increase the chances of an auction[161].

The question is whether it is desirable to effectuate an auction process at all, and in so doing granting the shareholders the authority to decide about this.

It has been argued that an auction market would decrease the possibility of a tender offer, since increased premiums diminish the ability of the bidders to initiate hostile takeovers, and would therefore reduce the positive effects of hostile takeovers[162]. On the other hand, without an auction market the shareholders would be deprived of the possibility of having a share in high takeover gains deriving from competing offers[163]. Furthermore, a potentially low premium might result in excess hostile takeover activity which eventually harms both bidder and target shareholders, especially since they might lead to ill-considered takeovers and under priced offers[164].

Therefore, there has to be a balance between enhancing the probability of an offer, which means lowering the availability of defensive measures, and increasing the premium,

[161] Romano, *supra* note 94 at 156.
[162] *Ibid.* at 158.
[163] *Ibid.* at 164.
[164] Coffee, *supra* note 45 at 1157.

which means strengthening the position of the target company by giving it more ways to defend itself[165]. Since it is the shareholders to whose benefit both consequences work in the end, it is in their hands to show their preference by allowing them to approve of defensive measures[166]. To achieve a balance on a broader scale in the future, it should be ensured that the deciding shareholders are well-informed and aware of the consequences of their choice, not only on the basis of a concrete offer, but also on a greater economic scale. This general information as well as the information concerning the concrete offer should be provided by the directors in an objective way, while reserving an advisorial function even if the shareholders ultimately decide themselves.

However, even if such a rule is passed, it is not only in the hands of the shareholders to influence the likelihood of an auction. Favourable auction conditions can be also be created by an extended minimum offer period and withdrawal rights[167], which give the management as well as the shareholders time and the opportunity to look for another bidder and to rethink their decision. Another consideration is that a white knight chosen by the management can compete with the first bidder. The possibility of entering into an auction by looking for a white knight without the authorization of the shareholders is given in most current regulations, such as the German takeover statute[168], especially since this procedure is not seen as a defensive measure as such[169].

The problems associated with the authorization by the shareholders include the limited time which is given for the shareholders to decide on the matter, especially since the minimum announcement period for a shareholder meeting can be quite long compared to the minimum offer period. A solution for that is to introduce shorter periods for the calling of a shareholders' meeting if its subject is a decision about defensive measures.

Then, the question is whether the majority shareholders have to regard the interests of the minority shareholders when deciding on the merits of a hostile takeover and whether it

[165] Bergstrom, Hogfeldt, Macey & Samuelsson, *supra* note 105 at 510.
[166] Romano, *supra* note 94 at 165f.
[167] *Ibid.* at 156.
[168] See §33 I WpÜG.

should be defended. In some countries, the shareholders are under a general duty to take into account the minority shareholders, such as in the US, whereas in others, such as in Canada, they are not. Another problem is that shareholders are normally under no duty to consider the stakeholders' interests, even if the management does[170]. Such a protection clause, however, might be introduced into a special takeover regulation as well. Special measures could be implemented to ensure the protection of stakeholders, even though this might imply higher transaction costs[171]. Another, preferable, solution is to ensure the protection of the interests of stakeholder, especially employees, by a special legislation outside the takeover regulation, as it is done, for example, in Germany, since it basically forms part of a subject which needs a regulation of its own, and has a broader application than just in the case of hostile takeovers.

Another difficulty is that the regular course of business might be hindered if the management no longer has the authority to take any actions if they resemble defensive measures. The special takeover regulation should not act as a disadvantage for decisions which have no relation to hostile takeovers. Therefore, there should be criteria to distinguish between which actions are permissible and necessary in the course of ordinary business, as as it was stated above[172].

(3) Anticipated authorization by the shareholders for defensive measures

A regulation might also contain the possibility that the shareholders approve of a defensive measure in advance before an actual bid has been made. This might refer just to a certain defensive measure, but also to a general kind of defensive measures, as was the stance of the recent German takeover statute[173].

The disadvantages of such a regulation are evident: while the shareholders are being deprived of their decisive power in the light of a concrete offer, the management, who

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[169] See B.II.
[170] „Pflicht des Vorstands“, *supra* note 85 at 488.
[171] *Ibid.* at 489.
[172] See D.II.2.a).

basically gets a blank cheque to take certain defensive actions, has much more freedom in its decisions[174]. This enhances the danger that the management takes actions in its own interest. If the management, however, wants to act in the interests of the company and the shareholders, it might have difficulties in determining which defensive measures are still adequate, and which would constitute an unjustifiable disadvantage[175]. On the other hand, a decision made in advance by the shareholders does not reflect and match their interests as accurately as a decision on the basis of an actual offer, especially since they are not given the opportunity to rethink their choice[176].

The argument that technical obstacles might render such a concrete approval difficult is not sufficient to explain the need for a pre-bid decision, since these obstacles might be substantially diminished by the corresponding regulation in the period for the announcement of the shareholders' meeting as well as the place and duration of the meeting[177].

The negative impacts on the decisive power of the shareholders and the possibility of improper management behaviour would be even worse if the shareholders were not merely voting for a concrete defensive measure, but for certain types of defensive measures.

The shareholder should always give their approval only after a concrete offer has been made. Of course, it is always in the hands of the shareholders when and whether they give their approval; however, they might often not be aware of the consequences of the loss of choice.

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[173] §33 WpÜG.
[174] Drygala, *supra* note 160 at 1865.
[175] R. Thaeter & D. Barth, „RefE eines Wertpapier- und Übernahmegesetzes" (2001) NZG 545 at 549.
[176] Drygala, *supra* note 160 at 1865.
[177] *Ibid.*

(4) Directorial discretion in adopting defensive measures

Another route would be to put the decision as to whether a takeover would be advantageous for the company and its shareholders or not, and therefore whether or not to defend against it, in the hands of the management, as is the case in the US. In doing this, the management has to act within its fiduciary duties and must not to follow its own interests, but apart from that it has the freedom to do that which, in its view, is in accordance with the company's interests.

This gives the management more flexibility and avoids problems with the distribution of powers. Furthermore, the current business strategies would not be disturbed by strict rules as to which actions management may take. Additionally, the management is seen as better suited to lead the business of the company due to its expertise and inside information, as well as to negotiate better offers from third parties[178].

This solution has many disadvantages as well. Firstly, whether the management complied with such a vague standard has in questionable cases to be controlled by subsequent judicial review, since its behaviour can only be assessed properly in the context of an established set of facts. This approach therefore involves much costly litigation with its disadvantages[179]. It might also lead to insecurity on behalf of the directors as to which behaviour is still acceptable or not.

Additionally, the higher the range of factors the management is given to consider in its decisions, the less control the shareholders and other stakeholders have in whether it really acted in their interests, and not in its own under the pretext of regarding other interests. It might be a possibility to think about additional controlling devices. This, however, is not necessary if it is ensured already in the takeover regulation that the management does fulfill its duties by setting clear standards and distribute the authorities

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[178] M. S. P. Baxter, „The Fiduciary Obligations of Directors of a Target Company in Resisting an Unsolicited Takeover Bid" (1988) 20 Ottawa L. Rev. 63 at 100.
[179] See D.II.1.b)(3).

accordingly, so that the shareholders and stakeholders do not have to subsequently litigate with an unpredictable outcome.

(5) Provision for additional defensive measures

The final possibility would be to provide additional defensive measures by way of the takeover regulation. This would be a clear sign from the legislature or regulator that it wanted takeovers to be hindered in its country due to political or economic reasons.

An example for the provision of defence mechanisms by law are the anti-takeover statutes in the US, which have been upheld there by jurisdiction, even though they have been widely criticized by legal literature, especially since the shareholders were not included in the process of adopting them[180].

Such an extension of the ways in which one can defeat hostile takeovers, however, should be subject to shareholder approval, since it clearly diminishes their rights to decide whether to sell their shares in a hostile takeover or not. The fact that shareholders in the US did not vote for equivalent charter amendments in the US earlier, when they had the opportunity, shows that the creation of additional defensive measures was not in their interests[181].

Consequently, such a regulation should never be imposed on the shareholders, but always put to their disposition. It should be ensured that once such a possibility is created, the shareholders should reserve the ability to opt out, so that they do not lose their authority. In this context, however, the economic impact of such regulations should be considered as well, and it should be clear to the shareholders that if takeovers become too difficult, it might in the end harm them, since they might lose the monitoring device of the market for corporate control.

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[180] „The Race", *supra* note 150 at 1172, 1180.
[181] *Ibid.* at 1187.

(6) Conclusion

In deciding how to regulate the behaviour of the management in regard to defensive measures, two basic approaches can be observed.

First, there is the approach which draws a line between the authority of the management and that of the shareholders, and in the area of competence of the shareholders, it requires their consent for certain courses of action. Depending on the requirements concerning the need for their approval, this distinction is followed very strictly and tries to leave the shareholders all possible latitude to execute their authority on a fully informed basis, or it has a tendency to provide the management with more flexibility by permitting advance approvals. As long as the management acts within its competence, or with an according approval, its actions are usually legitimate.

There are two different ways of establishing whether an action lies in the competence of the management or not, if it has not been approved by the shareholders. Firstly, the standard of judgement could be whether an action actually hinders the shareholders exercising their rights, especially the right to sell their shares. Second, an action could be assessed depending on whether it is able to deprive the shareholders of their rights, independently from whether it actually does or not. The last standard has often been preferred in existing regulations[182]. This seems to be the right approach, since the management has to be able to estimate in advance whether one of its actions might lie in its competence or would affect the rights of the shareholders. Moreover, it cannot be made dependent on the outcome of a transaction, which might be influenced by other factors, in assessing whether an action of the management was proper.

The intention of the management does not play any role in the regulations following that model either. This is consequent, because the distribution of powers and rights in a company is not based on subjective, but purely on objective standards.

[182] See e.g the German takeover statute, F.II.3.c)(4)(a).

The second way to treat this subject is to leave the whole authority to act in the situation of a hostile takeover with either the shareholders or the management. The first solution is, as it was stated above, not really practicable, and has not been realized within any of the jurisdictions examined here. The more common approach is to leave the authority to make decisions with the management also in the situation of a hostile takeover and to impose on it the duty to act in the interests of the company and its shareholders. For example, in the US and Canada it has been stated that in the context of takeovers and mergers, the power of the directors should not be delegated to the shareholders. That clearly means a rejection of the concept of shareholder decision power[183].

Since there is no clear distinction of authority like above, it has to be ensured that the interests of the shareholders, and maybe other stakeholders, will be met. The solution is to provide certain standards based on the fiduciary duties of the management stated in corporate law, and to provide the possibility of judicial review in the light of any special case afterwards.

The standard here is based on the actions of the management, not on the results, which makes sense due to the reasons cited above. In that context, however, it is important whether the standard is purely objective, and therefore simply judges the reasonableness of the action, or subjective as well, which considers the intentions of the management[184]. Since the management's fiduciary duty requires that it acted in good faith, it is inevitable that one ought to include a subjective standard. This has been done by most of the yardsticks developed to judge managerial behaviour[185]. This, however, causes additional problems with the concept of the fiduciary duty, apart from the lack of giving a clear indication of how to act. In supervising whether the directors complied with the standard, it is very hard to demonstrate whether a director acted in good faith or not[186], especially if the burden of proof is left on the plaintiff.

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[183] S. Romano, „Shareholder Rights Plans in Canada“ (1997) 30 Securities & Commodities Regulation 143 [hereinafter „Shareholder Rights Plans“] at 146f.
[184] Simmonds, *supra* note 148 at 167.
[185] See E.I.2.b)(2)(a), but also E.III.2.b).

The creation of additional defensive measures, on the other hand, is again a clear regulation of powers. However, since it gives the management even more authority than it had before, it inevitably comes close to giving the management all the power to act in the situation of a hostile takeover.

As a whole, objective regulation, which clearly protects the rights of the shareholders to decide about the defence of hostile takeovers and the establishment of the neutrality of the management with the requirement of shareholder approval for certain measures in the light of a concrete bid, seems to be the best solution. Contemporaneously, one must avoid an over-regulation with excessively detailed rules, which also often leads to efforts to evade them.

c) The time frame in which the rules apply

Another issue is whether the regulation only applies to defensive measures implemented after a concrete offer, or applies at an earlier stage, since pre-bid defensive measures can basically have the same effects if they are able to deter a hostile offer.

The problem is that a regulation which applies prior to a clear offer is made might restrict the freedom and flexibility of the management substantially[187]. Current regulations, therefore, mostly follow the principle that only a firm offer triggers the rules governing defensive measures.

Conversely, if only the time following an offer is regulated, the management might use the time before to establish sufficient defences, given that they are permitted by general corporate law and other regulations, to be able to fight off future hostile offers. In this way, the protection of the shareholders provided by special takeover regulation could be evaded[188]. If general corporate law and other regulations, as well as the economic structure of a country do not already provide enough protection, it might be necessary to

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[186] Simmonds, *supra* note 148 at 168.
[187] Merkt, *supra* note 16 at 250.
[188] *Ibid.* at 251.

regulate obviously preventative practices[189]. But in general, the use of many pre-bid defensive measures is already regulated, and often restricted, by general corporate law[190].

If the regulation only applies to the time after an offer, the moment which determines whether an offer has been made must be carefully defined. One possibility is the announcement of the offer. It might also be at the time when the management has reason to believe that an offer is about to be launched[191]. This would be the more certain course, since from then on the management is prepared to take measures against that prospective offer.

3. The characterization of the regulation as securities law or corporate law

Another question is whether takeover regulation belongs to the field of corporate law or securities law, or somewhere in between. Since the regulation of defensive measures affects both areas of law, as will be outlined below, a clear distinction is not possible. This is relevant for two reasons: First of all, since they both place emphasis on in some points differing interests, ways have to be found how to draft a regulation which takes into account, or at least does not harm, these interests. Secondly, the determination of the area of law it belongs to has an effect on the authorities which are practically concerned with its regulation, since in many countries, corporate law and securities regulation is assigned to different authorities. On the other hand, practical considerations might make one authority more suitable to regulate this subject than the other, even if this might contradict the legal distribution of authorities.

The underlying objectives of both areas of law are the following: Corporate law is in part concerned with harmonizing the conflicting interests of the participants of a corporation, especially between the management and the shareholders, the protection of the member rights of the shareholders, including minority shareholders, as well as the organization

[189] *Ibid.* at 251.
[190] E.g. the limitation of voting rights and the issue of dual class stock; Bergstrom, Hogfeldt, Macey & Samuelsson, *supra* note 105 at 497.
[191] Merkt, *supra* note 16 at 250; see Rule 21.1 of the City Code on Takeovers and Mergers.

and structure of a corporation[192]. The purpose of securities or capital market law is to ensure the functioning and efficiency of the capital market[193]. It focuses on the interests of the investors, whose faith in the capital market is essential for its operation[194]. In that context, its main concern is not the role of the shareholders as members of the company, but merely their financial interests, so that the consideration of the shareholders' needs in capital market law differs in some points from that in the corporate context[195].

It has been argued that since there exist many overlaps between the objectives of corporate law and capital market law, especially since capital market law is continuously expanding into fields which were originally assigned to corporate law, both areas should not be seen as separate, but rather as "parts of a continuum"[196]. This might in some ways be true, but in reality there still has to be a distinction. Firstly, the differing objectives lead to the different treatment of various aspects. Secondly, in many countries it is clearly divided between the two areas of law. This is especially the case in countries which have different authorities responsible for the two areas, such as in the US, where corporate law is dealt with by the courts at a state level, whereas the SEC administers the federal securities statutes, which exist alongside the state securities laws, the so-called "blue sky laws"[197].

The assignment to an area of law basically depends on the subject which is regulated. The regulation of the use of defensive measures can alter the fiduciary duties of the management as defined by corporate law, and in this context can be classified as such. This is especially the case if they are not regulated as part of a statute entirely regulating hostile takeovers, like in the US[198].

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[192] „Managementpflichten", *supra* note 44 at 1823.
[193] Heiser, *supra* note 50 at 60.
[194] Dimke & Heiser, *supra* note 66 at 242.
[195] *Ibid.* at 252.
[196] P. Moyer, „The Regulation of Corporate Law by Securities Regulators: A Comparison of Ontario and the United States" (1997) 55 U. T. Fac. L. Rev. 43 at 47, citing J.S. Ziegel, „New Look in Canadian Corporate Laws" in J.S. Ziegel, ed., *Studies in Canadian Company Law*, vol.2 (Toronto: Butterworths, 1973) 1 at 66.
[197] *Ibid.* at 48.
[198] See The Williams Act, E.I.2.a).

This raises the question of whether defensive measures therefore have to be entirely regulated under corporate law and by the applicable authorities. The main argument in favour of this approach is the structural logic, and the fact that other corporate law principles will be regarded when assessing the subject. However, this might not be enough. Even though the subject of defensive measures basically belongs to classical corporate law, they might be better regulated at the capital market level. The reason for this is, firstly, that the whole subject matter of hostile takeovers can rather be assigned to capital market regulation than to corporate law, and that defensive measures should be regulated in the context of the whole subject. Secondly, the aims of capital market regulation, which are to ensure a functioning capital market, can only be reached if it is ensured that shareholders are free to sell their shares, and that they are not hindered in doing so by defensive measures taken by the management. And last but not least, while the authorities dealing with corporate law have more core competence in fiduciary duties, the authorities dealing with securities law have a better knowledge of the whole subject of hostile takeovers[199]. Additionally, the securities administrators are closer to the participants in the capital markets and have the corresponding in-sight knowledge and expertise, and are therefore in a good position to assess the actual practical needs, to which they can adapt their regulation and rulings if it proves necessary. Consequently, it is justifiable, and in some ways even preferable, to regulate defensive measures on a capital market level. However, independently from which authority finally regulates defensive measures, it is essential that it cooperates with the other side, since only in this way is it ensured that both areas of expertise are shared.

In which way hostile takeovers are then actually regulated differs among the relevant countries. If the regulation is not established by law, but as a self-regulation by a securities administrator, it indicates that hostile takeovers are regulated at the capital market level[200]. The explicit regulation of hostile takeovers by law or jurisdiction can ultimately mean both, especially in countries such as in Germany, which do not have powerful securities administrators, but regulate most matters of both fields via statute. In

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[199] Moyer, *supra* note 196 at 67f.

[200] See e.g. the rules and policies concerning defensive measures set up by the Canadian securities administrators, E.III.2.c).

legal literature, the regulation of hostile takeovers in Germany has often been entirely assigned to capital market law. The British City Code on Takeovers and Mergers with its links to the stock market can be assigned to capital market law as well. In the US, on the other hand, defensive measures as a corporate law matter must not be regulated by securities administrators[201].

Independent from the level at which the regulation of hostile takeovers is finally exercised, it will always affect the other area of law, and therefore one should try to avoid conflicting systems by coordinating the two. Some commentators, assuming that the regulation of hostile takeover belongs to capital market law, believe that capital market law is the more applicable, super-ceding corporate law as the more general law[202]. Since this is not a general view and also questionable given the importance and different applicability of corporate law, simply imposing any regulation at the capital market law level without regard for basic corporate law principles does not provide a solution solving the underlying conflict. This would be even less justifiable if the regulation did not have the status of binding law. On the other hand, at a time when the provision of capital via the securities markets becomes more and more significant for a company to function as opposed to financing via the banks, this is a factor crucial to the welfare of the company and its shareholders and stakeholders. Therefore, it should not be subordinated to any conflicting corporate law principles.

The best approach would be to try and meet the different objectives by regulating the question of defensive measures while taking into account all other affected interests. Since a functioning capital market and the market of corporate control both favour the interests of the shareholders to keep the opportunity to sell their shares at a premium, which also ensures an external control mechanism, which reduces agency costs, the regulation of defensive measures in a way that protects the decision power of the

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[201] Moyer, *supra* note 196 at 48.

[202] „Managementpflichten", *supra* note 44 at 1823; Wiese & Demisch, *supra* note 67 at 849; but see also Heiser, *supra* note 50 at 60, stating that capital market law is generally subordinated to corporate law.

shareholders ultimately serves both purposes, so that no real tensions between both fields of law occur[203].

Due to their in other aspects conflicting aims, incompatible results might be achieved nevertheless. Firstly, hostile takeover regulation by way of capital market law seems to put more emphasis on the protection of the freedom of the shareholder – in this case the investor - to sell their shares to a hostile bidder, and is in that respect more efficient in assigning the shareholders the opportunity to decide. On the other hand, the interests of other shareholders, which are not purely financial investors, like strategic shareholders or employees holding stakes in the company as a form of compensation, which are also protected by company law, are not subject to the protection of capital market law[204]. Secondly, in assigning the authority to decide about defensive measures to capital market law, the shareholders might not have to regard the stakeholder interests when making their decision. The same might apply for decisions of the management. If it does not have to consider stakeholder interests in a special legislation regulating hostile takeovers, but has to consider them under general corporate law, the result might be that there is a difference in the treatment of hostile takeovers in opposition to other forms of mergers[205]. On the other hand, traditional corporate law seems to focus more on the principal-agent-relationship, and therefore does not provide the shareholders with such extensive powers, since it leaves the decision making power mainly in the hands of the management.

However, as a response to these concerns, the following has to be considered: Firstly, whether the majority shareholders have to regard the interests of the minority shareholders depends on the particular country[206]. In countries which have the concept of a fiduciary duty of majority shareholders towards minority shareholders, an according provision should be inserted into the regulation. Secondly, in respect of stakeholder interests, it should be noted that even if the considerations of the company encompass them to some extent, their interests are still not prevailing in respect of the shareholders'

[203] "Managementpflichten", *ibid.* at 1823.
[204] Heiser, *supra* note 50 at 60.
[205] „Szenarien", *supra* note 49 at 109.
[206] See D.II.2.b)(2).

interests. Also, it generally also benefits the stakeholders if the company has better opportunities to raise capital, so that a functioning capital market is, in some respects, in their interests as well. All the possible disadvantages might be regulated by special legislation designed to protect stakeholders, such as by way of labour laws. And finally, even if the shareholders get to make decisions about the use of defensive measures, that does not mean that the principal-agent-relationship is void. The management still usually has the better skill and insight, and its role in that context is to communicate knowledge to all shareholders in such a way that they understand the issues and that they are able to make a well thought out decision.

Following the aims of capital market law in regulating hostile takeovers, normally a subject of corporate law, does therefore not mean that it generally contradicts corporate law, as long as the additional aims of the latter can be otherwise met. On the whole, in light of the considerations made above, it is better to regulate defensive measures by securities regulation rather than corporate law.

4. Further consequences of a regulation on hostile takeover activity

An explicit regulation is the most direct way to influence hostile takeover activity, as was stated above. Moreover, the implementation of a facilitating regulation might remove additional barriers, such as structural and technical barriers, due to a change in attitude and economic practices concerning hostile takeovers. If more takeovers occur and become increasingly common, shareholder structures will change and capital markets will open up even more. However, some of the barriers to hostile takeovers might still remain, even under the influence of a takeover-friendly legislation, as many of the structural characteristics are an expression of the general attitude concerning the role of the company, its shareholders, management and stakeholders[207].

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[207] Jenkinson & Mayer, *supra* note 29 at 26.

III. The role of harmonization

The divergence of rules concerning defensive measures in hostile takeovers between different countries can have significant economic consequences. A country might be disadvantaged if its companies are not taken into account as possible targets due to high costs and a low probability of success for any hostile takeovers, and possible bidders turn to business opportunities in other countries instead. This might make it more difficult for a country to participate in the international capital and investment market[208]. On the other hand, if the impediments to taking over companies in a given market are very low compared to other countries, it might be under an increased pressure to be taken over[209]. This does not necessarily constitute a disadvantage to the countries with lower takeover barriers, since that country's companies will have a larger opportunity to refinance themselves[210]. Therefore, it is not necessary to harmonize just to create a level playing field concerning the degree of defensive barriers permissible. However, it is eventually desirable to have a harmonized regulation, since the equality of economic conditions does enhance the growth of international markets.

The lack of harmonization can lead to competition between different regulation systems. The choice of incorporation of the companies might be influenced, depending on the regulation of takeovers, which the countries might use to attract companies[211]. This might have the positive effect that each country is looking for the most efficient regulation. Conversely, if one of the interest groups has a stronger position or lobby than another, the competition might be focused on which country favours that interest group more, and could either result in very takeover friendly or extremely defensive regulation. An example for such a development is the US state law, where every state tries to create a regulatory environment favouring the interests of the directors.

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[208] Merkt, *supra* note 16 at 225.
[209] *Ibid.* at 226-227.
[210] Dimke & Heiser, *supra* note 66 at 258f.
[211] Merkt, *supra* note 16 at 226.

Harmonization can occur in two different ways: commonality and reciprocity. Commonality means the creation of a uniform international regulation, whereas reciprocity would consist of the mutual acceptance of the rules of other participating nations, which all apply to a certain minimum standard[212]. The second approach is more likely to be adopted, since each country has to give up less of its national sovereignty, and can still consider its national characteristics[213]. However, unlike in other fields of law, such as many aspects of securities law, not all countries are interested in one common standard governing the regulation of hostile takeovers. Market and competition concerns inclinate them in favour, but hostile takeovers touch also very sensitive areas, which are still very much influenced by national characteristics, such as employment and shareholder structures[214]. Consequently, the necessary cooperation might not be achieved very easily, which would hinder a harmonization process substantially.

IV. Conclusion

The conclusions made above concerning every aspect of how defensive measures in hostile takeovers should, ideally and from a theoretical point of view, be regulated, can be summarized in the following way:

First of all, an explicit regulation is necessary, since only in this way can the treatment of defensive measures and their influence on hostile takeover activity be regulated effectively. The best form of regulation would be a general, but not exhaustive set of principles established by a self-regulatory body with the possibility of judicial review of the decisions made in this context, since this would provide the highest degree of flexibility combined with a judicial control as a last resort. In doing so, the administrative body being best suited to establish such a regulation would be the securities administrators, perhaps combined with representatives of the economy and other regulative bodies in that context, since they have greater knowledge of hostile takeovers, and know best the needs of the capital markets. They should seek to align the treatment of

[212] Bourtin, *supra* note 212 at 1641.
[213] *Ibid.* at 1638.
[214] Bourtin, *supra* note 212 at 1638f.

the subject of defensive measures with the principles of corporate law, since their regulation basically affects both capital market law and corporate law. In areas which are not covered by securities regulation, such as the protection of stakeholder interests, the creation of explicit legislation concerned with these subjects should be considered, but as separate areas, they should not be inserted in the regulation of hostile takeovers.

An alignment of both areas of law and the fulfillment of their objectives, with only a few exemptions, is possible if the treatment of defensive measures is regulated the following way: The management should not interfere with the ability of the shareholders to decide whether they want to sell their shares to a bidder or not. Therefore, the management should only be permitted to take defensive measures with the approval of the shareholders, which is given in the light of a concrete bid and only for a specific defensive measure. Otherwise, the management should advise the shareholders on their decision, on a purely objective and accurate basis.

It is normally sufficient if the regulation takes effect only after a concrete offer has been made, since otherwise, the normal course of business is hindered. Additionally, many pre-bid defensive measures are already regulated in other provisions, such as in general corporate law. If, however, there is a danger that otherwise non-restricted pre-bid defensive measures are aimed at and capable of precluding any offer, a regulation covering these measures might be considered.

Given the increasing internationalisation of the economy, it is advisable to harmonize regulatory approaches, especially among major trading partners, thus granting all countries the same opportunities to raise capital on the international securities markets. This, however, is difficult due to the still prevailing national differences, especially in the field of hostile takeovers.

E. EXAMPLES OF IMPORTANT EXISTING REGULATIONS

In the preceding chapters, the best practice for regulating defensive measures in hostile takeovers has been considered by evaluating all the different factors which are relevant in this context. This happened on a theoretical basis, without relating to a specific country, by describing all the aspects which should be considered while assessing this subject. These considerations have often been underlined by examples of particular regulations in different countries, whose main purpose was usually to clarify certain points, as well as to demonstrate the often existing diversity of the treatment of certain aspects.

In the following two chapters, ways to regulate hostile takeovers and defensive measures which have been applied in certain countries will be described in more detail. Emphasis will not only be placed on the core points of the regulation concerning defensive measures, and the general objectives of the regulation of hostile takeovers as such, but also on the political and economic background influencing hostile takeover activity and regulation. Another aspect considered will be the treatment of stakeholder interests in company law and in the takeover regulation, since this determines whether the directors are just the agents of the shareholders or whether they have to consider other interests in making their decisions as well. This plays an important role in assessing the scope of authority of the management to take defensive measures.

At the first stage, regulation of takeovers in the United States, the United Kingdom and Canada will be outlined, since they have experienced the phenomenon of hostile takeovers for some time compared to most others. These countries also all have a special position in that context, which explains why they have been chosen as examples in this work.

The US was one of the first countries where hostile takeovers occurred, and accordingly has examined the subject extensively in literature and practice. In some ways, its actual method of regulation influenced other countries, such as Canada, although it also has been subject to much criticism. In Europe consequently, it is more the theoretical background on hostile takeovers developed in the US which is drawn upon. Apart from that, given that the US is a major trading partner of many countries, its regulation has relevance for a lot of companies abroad.

The UK, on the other hand, has taken a leading role in Europe in serving as a pioneer and model in takeover regulation. This is mainly due to the fact that takeover activity and the capital markets in the UK have developed much earlier than in the other European countries.

Canada, however, is the country with the least settled way to regulate hostile takeovers, despite the fact that it is also very familiar with this phenomenon. This is partly due to the fact that various different authorities have taken up the task to set up rules in that context, and that in doing that, on the one hand there is a tendency to apply principles deriving from US law, and on the other hand, the UK approach is taken as a model. This reflects very clearly the conflict and differences between the two approaches, and the need to render them compatible.

In the second chapter, recent developments of takeover regulation will be described to show how countries which do not have a long history of takeovers approach the subject.

First of all, the discussions about the creation of a European Directive will be outlined. In this context, the emphasis is not only on developing a new regulation, but also in harmonizing existing regulations within the EU, and to choose the best model. This has significance not only for countries within the EU, but also for their trading partners.

Secondly, the recently enacted German takeover statute, which does not comply with the draft of the European Directive as it currently stands, and its development will be presented as an example of a regulation contradicting the general European line.

These two chapters show clearly the different approaches which have been taken regarding defensive measures in hostile takeovers. In describing these different ways of regulation and their backgrounds, it will be shown that often not only do the theoretical considerations play an important role in influencing a regulation, but also political and social considerations, even if they contradict legal and economic rationales. This demonstrates one more time that theory and practice often substantially deviate from each other.

I. US

1. Political and economic background

The political and economic background of hostile takeovers and their regulation in the US is substantially influenced by two different features: first, the fragmentation of shareholders and second, the lack of cross-shareholdings. This is partly the result of regulations which limit the American banks' involvement in corporations[215]. Second, only some aspects of hostile takeovers are regulated on the federal level; defensive measures, in particular, are treated by jurisdiction and statutes on the state level.

Characteristics of the American companies include their one-tier board, the existence of independent directors, the lack of employee codetermination, the fact that they finance themselves to a high degree on the securities markets instead of turning to bank credits, as well as a tradition of entering into explicit rather than implicit contracts[216]. Also, the directors in the US traditionally have much power due to the fragmented ownership, which led to the development of the Berle-Means-Corporation. A relatively new development that started in the 1990s, is the increasing shareholder activism by institutional investors, which provides additional control of the management[217].

So far, the US has experienced five large merger waves. In the 1960s and 1970s, these waves were characterized by a trend towards conglomeration. In the 1980s, however, a

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[215] Such as the McFadden Act, the Glass-Steagall Act and the Bank Holding Company Act; see "Some Differences", *supra* note 74 at 1930.

[216] G. Miller, "Special Symposium Issue: Political Structure and Corporate Governance: Some Points of Contrast between the United States and England" (1998) 1998 Colum. Bus. L. Rev. 51 at 51.

divestiture movement started[218] and a market for junk bonds developed, which made it easier to raise the financial means to effectuate an acquisition. Both phenomena gave way for the development of hostile takeovers on a broader basis[219].

When hostile takeovers started to occur more frequently, they were strongly opposed, especially by the management and employees due to fear of losing their position. That resistance diminished towards the end of the 1990s, even though criticism has not vanished entirely. This was partly because of the rising numbers of golden parachutes and stock options held by directors as well as less concerns about the loss of employment, since many hostile takeovers happened in growth sectors with more job opportunities[220].

2. Hostile takeover regulation

a) Federal regulation - The Williams Act

The federal statute directly regulating hostile takeovers is the Williams Act of 1968, which is an amendment to the 1934 Securities Exchange Act[221]. Its regulation of tender offers intends, among others, to improve the protection of the target's shareholders and to provide them with equal treatment. This happens by imposing strict disclosure rules, giving the shareholders extensive rights to withdraw their acceptance, ensuring that the shareholders are considered on a "pro-rata-basis" if the demand exceeds the offer and that all shareholders achieve the highest price paid to any shareholder, setting up a minimum time frame of 20 business days for the validity of the offer as well as establishing anti-fraud rules[222]. In this way, the target shareholders get sufficient information and time to decide whether to tender their shares or not. Also, competing bids are not oppressed due to a limited time frame after the offer[223]. Compared to other offer regulations, however,

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[217] Sudarsanam, *supra* note 56 at 20.
[218] Gilson, *supra* note 87 at 167.
[219] *Ibid.* at 168f.
[220] Black, *supra* note 10 at 807f.
[221] Klein & Coffee, *supra* note 38 at 168; tender offers are regulated in rules 14 (d) and (e) of the Securities Exchange Act of 1934 (15 U.S.C. 78).
[222] Emanuel, *supra* note 27 at 491f.; see rules 14 (d) and (e) of the Securities Exchange Act of 1934.
[223] Klein & Coffee, *supra* note 38 at 168.

the restrictions imposed on the offering party by the Williams Act are relatively mild[224]. The Williams Act does not regulate the behaviour of the directors of the target company.

b) State regulation

Initially, legislation concerning hostile takeovers was considered to be the province of the federal government. Only later in the 1980s did this understanding change and the states were permitted to enact their own regulation of hostile takeovers in areas such as defensive measures[225].

(1) State anti-takeover statutes

Anti-takeover statutes, which started being enacted in 1968[226], are basically aimed at protecting the board of target companies by providing additional means to defeat a hostile takeover. Anti-takeover statutes often have the form of control share acquisition statutes, which means that the other shareholders have to approve of an acquisition of a certain percentage of shares so that the bidder eventually can obtain control, or supermajority/fair price statutes, which require either a majority of votes or the payment of a fair price to the remaining shareholders to enable the bidder to pursue a second step merger[227]. A third, more recent approach is the business combination statute, which forbids certain business combinations between the acquirer of the shares and the target company for a certain period of time, unless they are permitted by the incumbent directors or if the bidder acquires a supermajority of shares[228]. Additionally, constituency statutes have been passed to enable the directors to consider other interests than the ones of the shareholders, which will be described in more detail below[229].

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[224] See E.II.2.c)(2).
[225] M. J. Roe, *Strong Managers, Weak Owners* (Princeton, New Jersey: Princeton University Press, 1994) [hereinafter "Strong Managers"] at 154.
[226] "The Race", *supra* note 150 at 1178.
[227] "Verteidigungsmaßnahmen", *supra* note 23 at 50f.
[228] "Verteidigungsmaßnahmen", *supra* note 23 at 51; see 8 Del. C. § 203 (2001) (which represents the Delaware anti-takeover statute).
[229] See E.I.2.b)(3).

(a) Edgar v. MITE Corp.

In *Edgar v. MITE Corp.*[230], the Illinois anti-takeover statute, which determined that the secretary of state could assess the fairness of an offer and decide about its registration[231], was declared invalid by the Supreme Court with the reasoning that it unconstitutionally burdened interstate commerce[232]. Also, the Supreme Court interpreted the Illinois anti-takeover statute as conflicting with the Williams Act and stated that the Illinois anti-takeover statute, which prevented the success of an offer even though it complied with the Williams Act, frustrated its objectives of not to discourage hostile takeovers and favour any interests over the others[233]. This decision rendered similar anti-takeover laws unconstitutional[234]. The anti-takeover statutes passed after that decision have been called "second-generation" statutes[235], as opposed to the first-generation statutes enacted before.

(b) CTS v. Dynamics Corp.

In *CTS Corp. v. Dynamics Corp. of Am.*[236], the Supreme Court upheld the anti-takeover statute of Indiana, which prevented the bidder from voting its shares if he passed a certain threshold of ownership, unless a majority of the prior non-bidding shareholders approved it[237].

In this decision, the Supreme Court acknowledged the ability of the states to enact their own takeover legislation, under the condition that it does not make the compliance with the Williams Act impossible[238]. *CTS* thus opened the way for the competence of the states to enact anti-takeover legislation. This judgment held up many other anti-takeover statutes, even if their ways of impeding hostile takeovers were different.

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[230] *Edgar v. MITE Corp.* (1982), 457 U.S. 624 [hereinafter *Edgar*].
[231] "Verteidigungsmaßnahmen", *supra* note 23 at 48.
[232] *Edgar, supra* note 230 at 640-643.
[233] *Ibid.* at 631-634.
[234] "Strong Managers", *supra* note 225 at 158.
[235] D. J. Block, J. M. Hoff & H. E. Cochran, "Defensive Measures in Anticipation of and in Response to Unsolicited Takeover Proposals" (1997) 51 U. of Miami L. Rev. 623 at 657.
[236] *CTS Corp. v. Dynamics Corp. of Am.* (1987), 481 U.S. 69 [hereinafter *CTS*].
[237] Emanuel, *supra* note 27 at 506.
[238] *CTS, supra* note 236 at 78f.

(2) State case law

Since most publicly held corporations are incorporated in Delaware, most of the relevant case law concerning the use of defensive measures in hostile takeovers comes from that state [239].

(a) The Unocal doctrine

When making business decisions, the directors of a company have to fulfill certain fiduciary duties, which include the duty of care and the duty of loyalty. The duty of care implies that the directors have to act with the degree of care a reasonable person would employ in similar circumstances[240]. The duty of loyalty means that the directors place the interests of the company and the shareholders ahead of their own interests[241].

In general, the courts apply the business judgement rule to determine whether the directors have acted accordingly to the duty of care[242]. The standard used is whether the directors have acted "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"[243]. It is presumed that the directors have satisfied these requirements, so that the burden of proof to demonstrate otherwise is on the plaintiff[244].

The level of scrutiny in judging the behaviour of the directors in relation to a hostile takeover, however, is enhanced and constitutes a modified business judgement rule. Due to the conflict of interests, as well as of competencies, between the board and the shareholders in the event of a hostile takeover, the courts cannot apply the same standards

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[239] Emanuel, *supra* note 27 at 515.
[240] Block, Hoff & Cochran, *supra* note 235 at 624.
[241] *Ibid.*
[242] *Ibid.*
[243] *Ivanhoe Partners v. Newmont Mining Corp.* (Del. 1987), 535 A.2d 1334 at 1341.
[244] Block, Hoff & Cochran, *supra* note 235 at 625.

as in a normal situation, where the directors are not threatened to lose their positions and where shareholders cannot be involved in corporate decisions[245].

The modified business judgment rule does not only apply special standards according to the situation of a hostile takeover, but also shifts the burden of proof of their fulfillment to the management[246]. In *Unocal*, this standard was developed in a two step test to determine the legitimate use of defensive measures in hostile takeovers.

First, the directors must have reasonable grounds to believe that there was a danger in the company's policy and effectiveness deriving from the takeover attempt[247]. This part of the test can be satisfied by showing that the directors acted in good faith and upon reasonable investigation[248]. This requirement of the Unocal test is more likely to be seen as fulfilled by the courts if the takeover measures were approved by a board whose members are mainly independent directors[249].

Second, the measures taken must be reasonable in relation to the threat posed. Whether this is the case has to be assessed by the directors considering the nature of the bid and its effect on the target company[250]. That second step was later refined in *Unitrin*[251], which requires that the defensive measures must not be "coercive or preclusive", and that they fall within a "range of reasonableness"[252].

The test generally applies both to pre-bid as well as post-bid defensive measures[253]. A pre-bid defensive measure, however, is more likely to remain valid since the courts

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245 "The Proper Role", *supra* note 21 at 1198, see also *Unocal, supra* note 61 at 954.
246 Block, Hoff & Cochran, *supra* note 235 at 625.
247 *Unocal, supra* note 61 at 955.
248 *Ibid.*
249 *Ibid.*
250 *Ibid.*, giving examples of factors to be considered.
251 In *Unitrin, Inc. v. American Gen. Corp.* (Del. 1995), 651 A.2d 1361 [hereinafter *Unitrin*]at 1384 three types of threats (opportunity loss, structural coercion and substantive coercion) are pointed out.
252 *Ibid.* at 1387f.
253 "Dead-Hand-Bestimmungen", *supra* note 25 at 192.

assume that due to less pressure on the board, it can make a more reasonable decision[254]. A previously-announced transaction is also much more likely to be held up[255].

Not only the implementation of a defensive measure, but also the board's refusal to redeem it after a concrete offer, such as a poison pill plan, can be subject to the test[256].

(b) The Revlon duties

Even more enhanced scrutiny is required if the target's directors initiate a bidding process to sell the company, which has been established in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[257]. In that case, the directors become auctioneers, and have the duty to obtain the highest price for the shareholders[258]. Also, a level playing field must be created, which means that all bidders must be treated equally; no bidder should be favored over another[259].

The Revlon duties also apply if the company is not explicitly up for sale in the course of a bidding process, but if a company abandons its long-term strategy and pursues a transaction which inevitably leads to the dissolution or the break-up of the company[260]. On the other hand, a mere action which might put the company in play (e.g. a merger) and which attracts a hostile bid, does not trigger the Revlon duties[261]. In that case, only the Unocal standard has to be fulfilled.

Enhanced scrutiny in the sense of the Revlon duties is applied as well if the board sells only the control of the company, but not the entire company[262]. This is, however, only the case if it merges into an acquirer which will have a shareholder holding the majority of the votes, not if it eventually remains in public hands[263]. The reason for this is that if a

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[254] *Moran v. Household International, Inc.* (Del. 1985), 500 A.2d 1346 [hereinafter *Moran*] at 1350.
[255] Emanuel, *supra* note 27 at 532.
[256] Block, Hoff & Cochran, *supra* note 235 at 640.
[257] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (Del. 1986)., 506 A2.d 173 [hereinafter *Revlon*].
[258] *Ibid.* at 182.
[259] *Ibid.* at 184.
[260] *Paramount v. Time, supra* note 61 at 1150.
[261] *Ibid.* at 1151.
[262] *Paramount Communications v. QVC Network* (Del. 1994), 637 A2d. 34 [hereinafter *QVC*] at 39.
[263] See *QVC, supra* note 262 at 46f.

company merges into another company with a controlling shareholder, the current shareholders would become minority ones and would in the future be deprived of the possibility of obtaining a control premium for the loss of voting power. Therefore, it has to be ensured that they obtain the best value reasonably available[264].

(c) The impact of case law on the use of defensive measures

One of the consequences of the standards outlined above is that if the Revlon duties do not apply, and the Unocal principles are not violated, the directors can "just say no" to an offer, even if it includes a high premium[265]. Poison pill plans stand up to these standards, as long as they do not substantially foreclose hostile tender offers[266]. This acceptance of poison pill plans constitutes the most significant consequence of that jurisdiction, since it gives the directors a considerable amount of power[267].

A more recently developed supplement to poison pill plans, the so-called "dead-hand provisions" (also called "continuing director provisions"), which establish that only the current board of directors and specified successors can redeem a poison pill, have not been upheld in Delaware so far under the reasoning that in the actual case, the adoption was not authorized in the articles of incorporation[268]. However, the subsequent replacement of the directors after a hostile bid by a proxy contest can be made more difficult by the existence of a staggered board[269], established before the poison pill plan, or maybe the use of a different dead-hand provision than the one used in *Carmody*[270].

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264 *QVC, supra* note 262 at 42.
265 Emanuel, *supra* note 27 at 530-532.
266 *Ibid.* at 537.
267 L. A. Bebchuk & A. Ferrell, "A New Approach to Takeover Law and Regulatory Competition" (2001) 87 Virginia L. Rev. 111 [hereinafter "A New Approach"] at 123.
268 *Carmody v. Toll Bros.* (Del. Ch. 1998)., 723 A2d. 1180 [hereinafter *Carmody*] at 1191.
269 A staggered board implies that the directors' terms do not expire every year, and that the directors usually can only be removed due to a special cause, see D. A. DeMott, "Comparative Dimensions of Takeover Regulation" in J. C. Coffee, L. Lowenstein & S. Rose-Ackerman, eds., *Knights, Raiders and Targets* (New York: Oxford University Press, 1988) 398 at 410.

(3) Stakeholders' interests

In *Paramount v. Time* it was declared that directors are "not under any per se duty to maximize shareholder value in the short term, even in the context of a takeover"[271]. They "may consider, when evaluating the threat posed by a takeover bid ... the impact on 'constituencies' other than shareholders..."[272]. *Revlon* puts a condition on this possibility to take into account the interests of the stakeholders, requiring that "there are rationally related benefits accruing to the stockholders" and stating that "concern for non-stockholders is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder"[273]. The reason for this distinction is that in *Revlon* the only concern is who is going to be the final acquirer after the company is already up for sale. In *Unocal*, however, it is relevant what effect a bid and a subsequent acquisition would have on the company, its shareholders and stakeholders[274].

Many states passed constituency statutes explicitly allowing directors to consider non-shareholders' interests, the first one being in 1983 in Pennsylvania[275]. Unlike the other anti-takeover statutes, non-shareholder constituency statutes might affect the content of the duty of care as well as the judicial standards for reviewing defensive measures[276]. Apart from one exception, these statutes are permissive; that means the directors do not have a duty to act in accordance with them[277]. Therefore, the directors get more flexibility in their actions, but on the other hand, the statutes do not directly expand the stakeholders' rights and their protection, since they are not enforceable[278].

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270 "A New Approach", *supra* note 267 at 126.
271 *Paramount v. Time, supra* note 61 at 1150.
272 *Ibid.* at 1153.
273 *Revlon, supra* note 257 at 182.
274 „Szenarien", *supra* note 49 at 108.
275 Robilotti, *supra* note 60 at 542.
276 Orts, *supra* note 59 at 90, 92.
277 *Ibid.* at 29.
278 Kuras, *supra* note 62 at 310.

These statutes were widely criticized in legal literature with the arguments that they preserve inefficient jobs and production methods[279], and leave the directors a wide range of excuses to pursue their own interests and protect themselves from hostile takeovers[280].

The argument in favor of these statutes is that they provide the board with more flexibility to pursue a company's long-term strategic plan[281]. Also, they improve efficiency by aligning the interests of all participants in an enterprise[282]. Additionally, the stakeholders in the US are generally protected only by their contracts with a company and no other mechanisms, so that it can be justifiable to support their interests in the special situation of a hostile takeover[283].

However, considering the shareholders' interests in the short term does not necessarily mean that stakeholders' interests are not served in the long term, although it might have at first a negative impact. Since hostile takeovers enhance efficiency and productivity, the existence of this controlling and interfering market device can benefit the participants more in the long-term perspective than preserving inefficient structures in the short-term[284]. Therefore, giving the directors additional means to defend hostile takeovers might be counterproductive. Upholding these statutes in the end benefits the directors more than the shareholders and stakeholders[285].

(4) Reasons for the development of state takeover regulation

When the Williams Act was passed on the federal level, the intention was to find a balance between the interests concerned and not to hinder hostile takeover activity[286]. Among the states, however, there is a clear tendency towards management friendly

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[279] See Robilotti, *supra* note 60 at 537.
[280] *Ibid.* at 559.
[281] See Robilotti, *ibid.* at 539.
[282] Orts, *supra* note 59 at 133.
[283] J. C. Coffee, "The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups" (1988) Wisconsin L. Rev. 435 at 459f.
[284] Robilotti, *supra* note 60 at 560.
[285] E. D. Rodgers, "Striking the Wrong Balance: Constituency Statutes and Corporate Governance (1994) 21 Pepp. L. Rev. 777 at 810.
[286] Miller, *supra* note 216 at 54.

hostile takeover regulation by providing them with a wide range of defensive measures, which act as impediments to the success of hostile takeovers. This is for several reasons.

First, it is a response to the Federal Williams Act, which gives the bidder, compared to practices in other countries, considerable freedom in how to structure its hostile bid. Accordingly, the target needs a lot of flexibility to be able to defend itself also against disadvantageous bidder tactics[287]. The states provide this possibility by enlarging the management's range of action.

Second, regulative competition among the states causes them to follow basically the same line. Normally, the state of incorporation is chosen by following shareholder friendly corporate law[288]. The situation is different in the context of hostile takeover law. Here, the board has a substantial interest in initiating and influencing the choice of re-incorporation of its company to a state with management friendly regulation[289]. This might result in a lower share price which might make the company more susceptible to takeovers; however, the protection provided by law is perceived as much more efficient than a higher share price[290]. Therefore, the states are likely to adapt to the managerial interests in creating impediments to hostile takeovers in order to attract many incorporations. This is also the case for Delaware, which has a slightly less restrictive anti-takeover statute than other states, but is in the same line with the other states concerning its jurisdiction on the poison pill plans[291].

Third, a successful hostile takeover by a company incorporated and operating in another state often causes the company taken over to move[292].

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[287] De Mott, *supra* note 269 at 405.
[288] "A New Approach", *supra* note 267 at 13.
[289] Emanuel, *supra* note 27 at 506.
[290] "The Race", *supra* note 150 at 1175.
[291] "A New Approach", *supra* note 267 at 136.
[292] Emanuel, *supra* note 27 at 506.

Finally, the directors of a company usually have a stronger concentrated influence on politicians and legislators in a state than the mostly widely-dispersed shareholders, and therefore a better position for successful lobbying[293].

3. Conclusion and Outlook

Hostile takeover regulation in the US has been widely criticized, especially in legal literature, for its focus on directors' interests. In shaping the regulation, economic and legal considerations seem to have been of secondary importance in comparison with political influence and lobbying[294]. Consequently, control of the management is weaker, since one of the monitoring devices, the market of corporate control, is not as strong as the others. This is not compensated for by the more permissive possibility of derivative litigation in the US, since it is usually most successful in cases involving self-dealing or illegality, but not less drastic behaviour such as inefficiency, at which hostile takeovers are normally aimed[295]. Increasing shareholder activism, which like a hostile takeover acts as a means of control, can supplement the external control, but is not strong enough to entirely substitute it. Nevertheless, the further development of hostile takeover regulation seems to continue its current path.

The use of a poison pill plan as one of the most powerful instruments to defend hostile takeovers is still in the hands of the directors. State legislation or jurisprudence does not include shareholders in the decision making process to adopt a poison pill plan so far; it rather appears to point in the opposite direction[296].

The question remains as to what could be done to change this situation. A federal regulation would have the advantage that it would create a single regulation and a level playing field for companies in all states. Also, a new regulation could consider the harmonization with other countries, such as those in Europe. Additionally, there would

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293 *Ibid.*
294 "Strong Managers", *supra* note 225 at 151f.
295 Miller, *supra* note 216 at 52.
296 "A New Approach", *supra* note 267 at 124f.

probably be not as much pressure from interest groups, since it is likely they would have less influence at the federal level than on the local government at the state level. Targets and bidders would be evenly distributed, while in a state all companies are potential targets, but only a few are potential bidders for a target located in that state. It would be just as or even more likely that their target would be located in another state to which the takeover law of the home state would not apply[297]. Nevertheless, the influence of a regulation at the federal level cannot be excluded.

Also, the form of the regulation would have to be determined. A federal binding law might suffer from a lack of flexibility to adjust to a change in economic conditions[298]. However, centralized self-regulation, although possibly favourable, might not be as easily imposed in a country with a long tradition of state regulation of hostile takeovers. The SEC has in other areas proven to be powerful and could be the right authority to regulate hostile takeovers, including defensive measures. Strict separation of corporate law and securities regulation in the US, however, make such a solution unlikely.

Even though a federal regulation, independent from the form it would have, would still be the better alternative to serve all interests concerned, it is in reality very unlikely that this will happen in the future. Furthermore, it is just as unlikely that the states will change their direction. Even though criticism of hostile takeovers might have become less, directors and other groups interested in keeping the status quo still have a lot of influence[299]. It is doubtful that pressures for harmonization will be enough to effectuate changes, despite advantages to be had.

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297 "Strong Managers", *supra* note 225 at 155.
298 "A New Approach", *supra* note 267 at 142.
299 Merkt, *supra* note 16 at 235.

II. UK

1. Political and economic background

The United Kingdom has been described as the "pioneer" of European takeover law[300]. This is due to the fact that it started creating takeover regulations long ago, as opposed to other European countries. The reason for this is, among others, that the UK has a much more dispersed share ownership than the continental European countries, which is one of the main bases for an environment favourable for hostile takeovers[301]. Consequently, the UK was faced with this phenomenon, which occurred in waves similar to those experienced by the United States[302], and the resulting problems, much earlier than other European countries.

Other features of UK companies include, as in the US, a unitary board system and a lack of codetermination[303]. They are also characterized by the existence of independent directors. The necessity of these independent directors, which provide, among other things, an additional monitoring device of the managing directors, has been emphasized by The Cadbury Report for British Companies, which has recommended a clear distinction between independent and managing directors[304].

Additionally, the UK has, in common with the US, a well developed securities market, which companies tend to use in preference to large scale commercial bank lending[305].

There are, however, some notable differences in the corporate and political climate between the two nations. In the past, UK banks were restricted in their ability to hold shares in other companies and often needed the permission of the Bank of England to do

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300 Bergstrom, Hogfeldt, Macey & Samuelsson, *supra* note 105 at 497f.
301 *Ibid.* at 498.
302 Sudarsanam, *supra* note 56 at 1.
303 Miller, *supra* not 216 at 51.
304 S.4 of the Cadbury Report of the Committee on the Financial Aspects of Corporate Governance, London 1992, The European Corporate Governance Institute <http://www.ecgi.org/codes/country_documents/uk/cadbury.pdf>.
305 Miller, *supra* note 216 at 51.

so, which prior to 1980 was never granted[306]. After the repeal of this impediment, the incidence of bank ownership has risen, but nevertheless remained moderately concentrated[307], and is currently above American levels but significantly below levels seen in either Canada[308] or Germany.

It is relatively easy to obtain control over a British company after an acquisition has taken place, since the directors can be removed by a simple majority vote of the shareholders without the need to show good cause[309]. Another peculiarity of British company law is that in some ways it is easier to execute an acquisition after a takeover than in a non-hostile negotiated merger, such that the former sometimes can be the more convenient transaction[310].

In addition, in the UK, the interests of directors were not given as great a weight in the drafting of takeover regulation as they were in the US. This is can be partly attributed to the prevailing political climate. In every state in the US, directors have considerable influence, among other reasons because of the possibility to initiate a re-incorporation to another state[311]. This is not so in the UK with its national scheme of company registration. Moreover, in the UK, the legislative and judicial branches of government play a limited role in the regulation of hostile takeovers, which diminishes the need for focused lobbying. It is rather the representatives of the capital market and the concerned parties themselves, including potential target and bidder management and shareholders as well as banks and other financial institutions. Consequently, the emphasis is on taking into account all affected interests and formulating the appropriate regulation on that basis.

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[306] "Some Differences", *supra* note 74 at 1993.
[307] *Ibid.*
[308] De Mott, *supra* note 269 at 400.
[309] J. Guethoff, *Gesellschaftsrecht in Großbritannien*, 2nd ed. (München: Rehm, 1998) at p.40; s. 303(1) CA (1985).
[310] De Mott, *supra* note 269 at 410f.
[311] "The Race", *supra* note 150 at 1193.

2. Hostile takeover regulation

a) General company law

British company law states that the directors owe a fiduciary duty towards the company, which includes the interests of the shareholders as well as those of the stakeholders, and have to regard these interests rather than their own in the event of a conflict of interests[312]. If the directors do not act in accordance with their fiduciary duties, they can be held liable to account[313]. The precise scope of this duty is not laid down in the Companies Acts, but is defined at common law.

b) Case law

The starting point when examining British case law concerning defensive measures is *Hogg v. Cramphorn, Ltd.*[314]. It expressed the principle that the directors must not interfere with the shareholders' ability to accept an offer for the purpose of safeguarding their own position, which was deemed to be an improper purpose for the previous issuance of shares[315]. The argument that the directors believed that the policy chosen by them would be the best for the interests of the company was considered as irrelevant[316]. This and other decisions set up the fundamental rule that it is the shareholders who finally have to decide on the appropriateness of mounting a defence in the face of an attempted hostile takeover, and that it does not fall within the ambit of the directors' authority to interfere with that[317]. This is to be judged objectively and any subjective elements such as the intention of the management do not play a role. In a subsequent case decided by the Privy Council,

[312] Guethoff, *supra* note 309 at 42; see s. 310 CA (1985).
[313] *Ibid.*; see s. 727 CA (1985).
[314] *Hogg v. Cramphorn, Ltd. and others* (1963), [1967] 1 Ch. 254 [hereinafter *Hogg*].
[315] *Ibid.* at para. 21.
[316] *Ibid.* at para. 22.
[317] Miller, *supra* note 216 at 59.

however, this purely objective view was overruled[318]. In later cases, the proper purpose test was not referred to anymore[319].

Hogg was decided shortly before the explicit regulation of hostile takeovers, including defensive measures, in the form of the City Code on Takeovers and Mergers, came into force. Therefore, this case does not have much practical significance anymore, although it influenced Commonwealth law, including that of Canada[320]. The same applies for subsequent cases concerning hostile takeovers, which are relatively infrequent in Britain[321], and which have to be seen in the light of the City Code on Takeovers and Mergers, which applies to all listed companies which must abide by its provisions. The view of the courts have also partly been influenced by the City Code on Takeovers in their seeking to establish principles compatible with the Code[322].

c) The City Code on Takeovers and Mergers

The City Code on Takeovers and Mergers has been created in 1968 as an answer to the formerly perceived unfair and abusive tactics which have been used in hostile takeovers, and it was therefore aimed to ensure fairness and equality of treatment of all the parties concerned[323].

(1) The self-regulatory nature of the Code and the role of the Panel on Takeovers and Mergers

The Code is not binding law and has no legal sanction in the event of breach, but is subject to a self-regulatory mechanism under the governance of the Panel on Takeovers and Mergers, which supervises compliance with the Code. The Panel was formed in 1968

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[318] See *Howard Smith Ltd. v. Ampol Petroleum Ltd.*, [1974] AC 821 [hereinafter *Howard Smith*] at 836.
[319] J. H. Farrar, „Business Judgment and Defensive Tactics in Hostile Takeover Bids“ (1989) 15 Can. Bus. L. J. 15 at 31; e.g. *Heron International Ltd. v. Lord Grade* (Court of Appeal), [1983] BCLC 244; *Dawson International plc. v. Coats Patons plc.* (Outer House), [1989] BCLC 233 [hereinafter *Dawson*].
[320] De Mott, *supra* note 269 at 410; see also E.III.2.b).
[321] P. Frazer, "The Regulation of Takeovers in Great Britain" in J.C. Coffee, L. Lowenstein & S. Rose-Ackerman, eds., *Knights, Raiders and Targets* (New York: Oxford University Press, 1988) at 436.
[322] Farrar, *supra* note 319 at 31, 38.
[323] Frazer, *supra* note 321 at 437.

by the governor of the Bank of England and the chairman of the stock exchange[324]. The Panel consists of representatives from, among others, the Bank of England, investment institutions, banks, accountants, the stock exchange as well as from industry[325].

If a bidder or a target company has a question concerning the legitimacy of a certain transaction in relation to the Code, it will apply to the Panel for a confidential consultancy[326]. The resulting decisions will be taken by the Panel Executive, and can be challenged before the full Panel. Against the rulings of the full Panel there is a right of appeal to the Appeal Committee[327]. Subsequently, an applicant, if still not satisfied, may seek judicial review of the Panel's determination. Such a review looks not at the correctness or otherwise of the Panel's decision itself, but rather assesses whether the Panel has properly observed its own rules and procedures in its deliberations and has paid sufficient heed to natural justice[328].

The Panel does not derive its authority from law, but its jurisdiction is supported, among others, by the courts and the stock exchange, and is backed by the UK government[329]. The sanctions for the violation of the City Code are therefore not legal, but practical. They can range from public criticism, which can injure a company's reputation, to the loss of the right to use the facilities of the securities market[330]. Put simply, a material and flagrant breach of the code would leave one unable to conduct business in the UK, with consequences ranging from one being unable to list on the London Stock Exchange, to having no bank willing to hold one's account. Companies authorized under the Financial Services and Markets Act 2000 might face enforcement actions by the Financial Services Authority, including fines, public censure and the removal of authorization[331].

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[324] *Ibid.*
[325] *Ibid.*
[326] *Ibid.* at 438.
[327] Sudarsanam, *supra* note 56 at 81.
[328] *Ibid.*
[329] *Ibid.* at 81f.
[330] Introduction to the Code 1 (c).
[331] Introduction to the Code 1 (c).

(2) The general content of the Code

The City Code on Takeovers and Mergers contains 10 General Principles, which are specified by 38 Rules. Its main objectives, expressed in the Principles, are the equality of treatment of all shareholders involved, the adequacy and equality of information, the functioning of the capital market as well as the duty of the directors to act in the interests of the shareholders[332]. It does not, however, concern itself with the commercial or economic merits of a takeover[333].

The Code explicitly regulates both the behaviour of the bidder as well as of the target directors, with rules of disclosure, a minimum offer period of 21 days, permission criteria for partial bids, a pro-rata provision for oversubscribed partial bids, restrictions on conditional offers and mandatory offers as well as the treatment of defensive measures[334]. It can be principally distinguished from the Williams Act on three points: First of all, unlike the Williams Act, it regulates defensive measures. Secondly, it sets up certain conditions for partial bids. The panel has to approve of a partial offer, and if it could result in the bidder holding more than 30 per cent of the target's shares, the consent of the majority of the shareholders is required. Moreover, share purchases during and after the bid are restricted[335]. Thirdly, a person who acquires 30 per cent of a company's shares has to make a mandatory offer to the remaining shareholders at the highest price paid in the last 12 months[336]. This demonstrates that the City Code on Takeovers and Mergers does not only regulate a wide range of relevant aspects to hostile takeovers, but that it also provides a comprehensive protection of the target shareholders, both from unfair bidder tactics, as outlined above and from any self-interest driven decisions by the directors which will affect their authority, as will be shown in the next section.

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[332] A. Zinser, "Der Britische City Code on Takeovers and Mergers in der Fassung vom 9.3.2001" (2001) RIW 481 at 482; see also the General Principles of the City Code on Takeovers and Mergers.
[333] See Introduction 1 (a) of the City Code on Takeovers and Mergers.
[334] DeMott, *supra* note 269 at 408f.
[335] See Rules 36.1, 36.3 and 36.5 of the City Code on Takeovers and Mergers.
[336] See Rules 9.1 and 9.5 of the City Code on Takeovers and Mergers.

(3) The regulation of defensive measures

Defensive measures taken by the target board are regulated in General Principle 7 and Rule 21 of the City Code on Takeovers and Mergers.

General Principle 7 of the Code states that after an offer has been made, or if the board has reasons to believe that an offer might be made, it must not take any actions without the approval of the shareholders "which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits".

Rule 21.1 of the Code lists special transactions where the approval of the shareholders is required. These are the issue of authorized but as yet un-issued shares, the issue or grant of options in respect of un-issued shares, the creation or issue of convertible bonds, the sale, disposal or acquisition of assets of a material amount and the entering into of contracts other than in the ordinary course of business, unless done in pursuance of an earlier contract. If there is no formal contract, but there might be an obligation or other special circumstances, the board needs to get the consent of the Panel to be able to proceed without the approval of the shareholders.

In addition, shareholder approval is required for the company to buy back its own shares during the course of an offer or earlier, if the target board already has reason to believe that an offer will be made, unless so done in pursuance of a contract entered into earlier[337].

The notes on Rule 21.1 specify and define some of the requirements and terms set up in Rule 21.1, as well as add a few special regulations. They especially determine that the contracts of the directors and their compensation schemes must not be substantially improved unless in the normal course of business or with the consent of the Panel[338].

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[337] Rule 37.7 (a) of the City Code on Takeovers and Mergers.
[338] Notes 6-8 on Rule 21.1 of the City Code on Takeovers and Mergers.

The board of the target company is obliged to get independent advice on any offer, the result of which it has to communicate directly to its shareholders[339]. Such a duty can already be derived from the general fiduciary duties of the directors towards their shareholders[340].

The directors are however, permitted to search for a white knight[341]. They have to give their opinion concerning the original and other competing bids to the shareholders[342]. This statement also has to be accompanied by valuations made by independent advisors[343].

These Rules do not preclude the possibility that other actions might be prohibited under the Code, which the Panel has not specified in advance. Accordingly, the Code states that not only the precise wording of its General Principles and Rules have to be observed, but also their spirit[344]. This enhances the flexibility of the Code, and prevents the danger that companies might attempt to find loopholes[345]. Thus there can be a breach of the Code without the violation of any specific rule[346].

In general, among the defensive tactics still permissible for a target board to take, but sometimes qualified with conditions by the Code or the Panel, are performance and profit announcements and forecasts, as long as they are made and revised with sufficient care[347], lobbying, the acquisition and divestment of assets within a certain framework, as well as the search for a white knight (given that it is classified as a defensive measure)[348]. Litigation and regulatory actions have been severely restricted by Panel jurisdiction[349].

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[339] Rule 3 of the City Code on Takeovers and Mergers.
[340] "Corporate Governance", *supra* note 79 at 798.
[341] „Verhaltenspflichten", *supra* note 19 at 1368.
[342] Rule 25.1 (a) of the City Code on Takeovers and Mergers.
[343] Rules 25.1 (a) and 3.1 of the City Code on Takeovers and Mergers.
[344] See Introduction to the General Principles: "[T]he General Principles and the spirit of the Code will apply in areas or circumstances not explicitly covered by any Rule."
[345] "A New Approach", *supra* note at 267 at 144.
[346] D. J. Berger, "A Comparative Analysis of Takeover Regulation in the European Community" (1992) 55 Law and Contemporary Problems 53 at 58.
[347] Rule 28.1 of the City Code on Takeovers and Mergers.
[348] Sudarsanam, *supra* note 56 at 201f.
[349] Berger, *supra* note 346 at 60.

Media campaigns often have to be approved by the Panel, and have to remain objective and accurate[350].

(4) The time frame in which the Code applies

The regulation of the Code concerning defensive measures steps in as soon as an offer is made, or the directors have reasonable grounds to believe that an offer will be made[351].

Defensive measures which can be set up before the occurrence of an offer might already be forbidden by the stock exchange regulations[352], and by company law. However, some of the defensive measures which are typically implemented before a firm bid are unknown or very rare in the UK, such as the classic poison pills or a staggered board of directors[353]. Employee share ownership plans which companies can use to accumulate share ownership in friendly hands are not permitted to be used as a poison pill[354].

d) Stakeholders' interests

The Companies Act determines that the "matters to which the directors are to have regard in the performance of their functions include the interests of the company's employees"[355]. This principle, however, allows employees no means of enforcement, so it essentially just gives the board more freedom in its considerations when making decisions[356].

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[350] Sudarsanam, *supra* note 56 at 202; see Rule 19 of the City Code on Takeovers and Mergers.
[351] See General Principle 7 and Rule 21.1 of the City Code on Takeovers and Mergers.
[352] Frazer, *supra* note 321 at 443.
[353] Sudarsanam, *supra* note 56 at 198.
[354] *Ibid.* at 200.
[355] Heiser, *supra* note 50 at 65.; s.309 (1) CA (1985).
[356] „Verhaltenspflichten", *supra* note 19 at 1369.

In the special cases of hostile takeovers, courts also have recognized that the directors do not only have to consider the shareholders' interests, but also other interests, which form part of the interests of the company as a whole[357].

The City Code on Takeovers and Mergers states in the Introduction to the General Principles that on the whole, the board has to act in the best interests of the shareholders, although the possibility to do so might be restricted by the General Principles of the Code. General Principle 9 of the Code describes the way in which the stakeholders' interests can be taken into account: "It is the shareholders' interests taken as a whole, together with those of employees and creditors, which should be considered when the directors are giving advice to the shareholders".

3. Conclusion and Outlook

The City Code on Takeovers and Mergers is very restrictive in the defensive measures it allows directors to take. At the same time, it also regulates the offer much more stringently, so that the target company need not fear unfair bidder tactics against which it would have to defend itself. In the UK one can therefore observe a pattern at odds to that of the US, where both bidder and target directors have considerably more freedom in their actions.

The reason why the UK and the US, which, as Anglo-Saxon countries share similar corporate roots and cultures, differ so widely when it comes to hostile takeover regulation lies mainly in the differences in political structure, as was outlined above[358].

Since its implementation, the Code has proven to be an efficient and successful method of regulation. Due to its success, the content of the regulations of the City Code on Takeovers and Mergers influenced many other European takeover regulations including

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[357] Heiser, *supra* note 50 at 65; see *Dawson, supra* note 319, Judgment of Lord Cullen, para. 26: "Directors have but one master, the company".
[358] See E.I.2.b)(4) and E.II.1.

the last draft of the 13th EU Directive, as well as, among others, the regulations in Spain, Portugal, Italy, Switzerland, Austria and Scandinavia[359].

Apart from its content, the Code has been very successful in its current self-regulative form, even though its particular method did not serve as much of a model to other countries as its actual content. The advantages of that system are evident: It is flexible, closely linked to business practice, quick in its decisions, and it avoids costly and time-consuming litigation, while it provides at the same time a last resort to which a company can turn to if it wants to appeal against a ruling of the panel.

A European Directive, which is currently being redrafted, might change the content of the current UK regulation, although the last draft, which has been refused, drew mainly on the UK model. One of the main fears of the UK was that a European Directive might change their form of takeover regulation by requiring that it had to be transferred into binding national law, which would lack the inherent advantages of self-regulation, as outlined above[360]. Therefore, the latest draft provided that its minimum requirements could be transferred into any kind of regulation, including self-regulation, which would enable the UK to keep the self-regulation of the Takeover Panel[361]. Therefore, if a Directive being enacted in the future would not deviate much from its first draft, minimal changes would be imposed on current UK takeover regulation. Should this not be the case, it must be doubted that the UK, which has an entrenched position regarding the preservation of the existing scheme of regulation, would acquiesce to such a Directive.

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359 "Corporate Governance", *supra* note 79 at 788f.
360 Sudarsanam, *supra* note 56 at 94.
361 H. Krause, „Die geplante Takeover-Richtlinie der Europäischen Union mit Ausblick auf das geplante deutsche Übernahmegesetz" (2000) NZG 905 at 906.

III. Canada

1. Political and economic background

Like the United States and the United Kingdom, Canada is a country with a relatively high level of acquisition activity[362]. Foreign takeovers play an important role, especially since the 1980s[363]. The Canadian economy is internationally highly integrated, particularly with the US[364]. Nevertheless, the political and economic background is in many ways different from the US, especially concerning the regulation of corporate law. Canada has a federal business corporations statute, the Canada Business Corporations Act („CBCA") as well as provincial statutes, as opposed to a regulation purely at the state level as in the US. There is no leading corporate regulation such as Delaware in the US, and neither is there significant provincial charter competition[365]. This is different, however, in securities regulation, which is left to the provinces and where Ontario takes the dominant role.

Additionally, Canada's big corporations do not have as diversified an ownership structure as the US companies[366]. Ownership or non-resident ownership is restricted in certain market sectors, such as the airline industry[367]. However, in comparison to the US, the subsequent gain of control is facilitated in Canada, since the directors can, like in Britain, be removed through a shareholder vote by ordinary resolution[368].

The structural and practical impediments to hostile takeovers, however, have not hindered the occurrence of an active and mature takeover market, with which the development of takeover regulation, compared to the US and the UK, could not keep pace so far.

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[362] DeMott, *supra* note 269 at 402.
[363] J.A. Brander, "Mergers, Competition Policy, and the International Environment" in R.S. Khemani, D.M. Shapiro & W.T. Stanbury, eds., *Mergers, Corporate Concentration and Power in Canada* (Halifax: The Institute for Research on Public Policy, 1988) 109 at 116.
[364] *Ibid.* at 120, 122.
[365] Kuras, *supra* note 62 at 312f.
[366] DeMott, *supra* note 269 at 400.
[367] Kuras, *supra* note 62 at 315.

2. Hostile takeover regulation

The regulation of hostile takeovers in Canada is varied, and does not follow a single path. On the one hand, there is the case law, which is based on the duty of care of the directors established in the CBCA. There are also the securities administrators, which adopted a unified National Policy, which shows similar elements as the British City Code on Takeovers and Mergers.

a) The CBCA

The Canada Business Corporations Act, the CBCA, used to regulate certain aspects of takeover bids, including the requirements of any offer, apart from defensive measures, until the end of 2001[369]. These provisions were first enacted in 1970 and inserted into the Canada Corporations Act, and were later transferred to the CBCA in 1975[370]. Since these provisions corresponded with those regulating takeover bids in provincial securities law, they have been repealed by Bill S-11 to avoid duplicative regulation and higher compliance costs[371]. These amendments are in force since November 2001.

Prior to that, in 1996, Industry Canada released a discussion paper with recommendations on how to achieve a harmonization of the CBCA with provincial securities laws with regard to the regulation of hostile takeovers[372]. The suggestion of the paper not to repeal the provisions of the CBCA treating hostile takeovers, but to merely adapt them and to additionally insert a code of conduct into the CBCA, which requires that all defensive measures have to be approved by the shareholders[373], have not been taken up in the amendments of the CBCA.

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[368] See, e.g. *Ontario Business Corporations Act* (*OBCA*), R.S.O. 1990, c. B.16, s. 122 (1).
[369] The regulation of takeover bids could be found in *CBCA,* R.S.C. 1985, c.C-44, s.194-205.
[370] Industry Canada, *Canada Business Corporations Act, Discussion Paper, Takeover Bids* (Ottawa: Industry Canada, 1996) [hereinafter "Discussion Paper"] at 4.
[371] Industry Canada, Corporate and Insolvency Law Policy Information, 16.05.2002, <http://strategis.ic.gc.ca/SSG/cl00150e.html>.
[372] "Discussion Paper", *supra* note 370 Executive Summary at (i), (ii).
[373] "Discussion Paper", *supra* note 370 Executive Summary at (iv).

The significance of the CBCA in the context of defensive measures therefore lies elsewhere: It imposes a duty of care on the directors, which is currently used as a standard in the court decisions about the appropriateness of defensive measures taken by the directors. The CBCA establishes that "every director and officer of a corporation in exercising their powers and discharging their duties shall (a) act honestly and in good faith with a view to the best interests of the corporation; and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances"[374].

The CBCA also enumerates that if the directors rely in good faith on financial statements, written reports, and the advice of persons such as lawyers and accountants, they will not breach their duty as specified above[375].

There is additionally the oppression remedy, which gives shareholders the right to complain if the powers of the directors „have been exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder"[376]. This might also be a standard at which to measure the behaviour of the management. It is usually, however, only the duty of care which is being used to assess directorial behaviour in hostile takeovers[377].

The provincial business corporation statutes have similar provisions about the duties of the directors[378]. The statutes do not however provide definitions of the scope of the prohibition against dishonest conduct, nor what constitutes acting in the best interests of the corporation. It is for the courts to determine the scope of the duty, especially in the context of hostile takeovers[379].

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374 *CBCA*, R.S.C. 1985, c.C-44, s.122 (1).
375 *CBCA*, R.S.C. 1985, c.C-44, s.123 (5).
376 *CBCA*, R.S.C. 1985, c.C-44, s.241 (2).
377 Simmonds, *supra* note 148 at 164.
378 See e.g. concerning the duty of care *OBCA*, R.S.O. 1990, c. B.16, s. 134 (1).
379 E. M. A. Kwaw, *The Law of Corporate Finance in Canada* (Toronto: Butterworths, 1997) at 23.

b) Case law

Compared to the US, there is not a large body of case law dealing with the proper behaviour of directors during hostile takeovers in Canada. This is one of the reasons why courts in Canada frequently refer to other common law jurisdictions. They often import the decisions of English courts, mainly due to the historical development of Canadian federal and provincial common law as the child of English common law, particularly in the commercial field. An increasing number refer to US decisions, which is explained by the fact that US law in many respects influenced Canadian law in respect of corporate statutes[380], and in the context of hostile takeovers due to a similarity in regulatory climate[381].

The starting point in Canadian takeover law is the case of *Hogg v. Cramphorn, Ltd.*, an English case, which has been referred to already above[382]. The principle was there established that the directors are not allowed to issue shares simply to retain control, which was held to be an improper purpose, notwithstanding the fact that they acted in good faith and tried to meet the interests of the company. This decision is referred to as the proper purpose test, which establishes that shares may only be issued for a certain purpose or types of purpose, in this case primarily the raising of capital[383].

This approach has been rejected by the Supreme Court of British Columbia in *Teck Corporation Ltd. v. Millar*[384], the leading case in Canada concerning defensive measures, on the basis that *Hogg* did not assess the intentions of the management in determining which was the purpose of their actions[385]. *Teck* also rejected the underlying assumption in

[380] M. S. P. Baxter, *supra* note 178 at 65.
[381] B. Welling, *Corporate Law in Canada, The Governing Principles*, 2nd ed. (Toronto: Butterworths, 1991) at 349; see also *Re Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.*, [1986] 59 O.R. (2d) 254 at 262 [hereinafter *Hiram Walker*].
[382] See E.II.2.b).
[383] Kwaw, *supra* note 379 at 42.
[384] *Teck Corporation Ltd. v. Millar* (B.C.S.C.), [1972] 33 D.L.R. (3d) 288 [hereinafter *Teck*].
[385] *Ibid.* at 312.

Hogg that the share issue power is limited to the raising of capital, and established that the only limits are that it is to be in best interests of the company [386].

Teck referred to *Re Smith & Fawcett, Ltd.*[387], a case decided in England in 1942, which stated that the directors have to exercise their powers in good faith in what they consider to be the best interests of the company and not what the courts consider as being the best interests of the company, and concluded that *Hogg* was not consistent with that[388].

The approach set out in *Teck* is that if the directors believe that a takeover might substantially harm the company, the defeat of the attempt to gain control by the directors might not necessarily be regarded as improper. The main criteria are that the directors act in good faith and have reasonable grounds for their belief. If this is not the case, then it will be found that the directors acted for an improper purpose[389]. In *Teck*, the purely objective approach of *Hogg* was therefore replaced by an assessment taking into account the motives of the directors.

One should note that in the opinion of the court, the burden of proof in demonstrating the lack of reasonable grounds lies on the plaintiff[390], which has been criticized, since the directors are the ones under a conflict of interest, which ought to lead to their having to bear the burden of proof[391].

Shortly after *Teck*, the Privy Council in England reviewed the appropriateness of the issuance of shares by directors in *Howard Smith Ltd. v. Ampol Petroleum Ltd.*[392]. It rejected the position that the only proper purpose for share issues is to raise capital as too narrow[393], and stated that it is impossible to clearly establish certain limits or detailed regulations for the behaviour of the management, since this approach could not match the

[386] *Ibid.* at 312; see also Welling, *supra* note 381 at 345.
[387] *Re Smith & Fawcett, Ltd.*, [1942] 1 All E.R. 542.
[388] See *Teck, supra* note 384 at 312.
[389] *Ibid.* at 315-316.
[390] Welling, *supra* note 381 at 346; *Teck, ibid.* at 330.
[391] Baxter, *supra* note 178 at 65.
[392] *Howard Smith*, *supra* note 318.
[393] *Ibid.* at 836.

variety of the situations. Also, a standard clause such as "bona fide in the interests of the company as a whole" or "for some corporate purpose" would not lead to entirely satisfactory results, since it essentially just restates the basic principle which it has to define. The court suggested that first one was to assess the nature of the power in question and the limits within which it may be exercised, then the substantial purpose for which it was used, and to finally reach a conclusion about whether the purpose was proper or not. In doing so, the bona fide opinion of the directors will be taken into consideration[394]. Under this approach, self-interest is the most common example of an improper motive, but the lack of self-interest does not make an issue of shares necessarily legitimate, either[395].

That case was criticized, however, as applying the old assumption as expressed in *Hogg* that there is a special list of purposes upon which directors can act, whereas in *Teck* it was assumed that there is no purpose other than regarding the company's best interests, unless the statute and the corporate constitution say otherwise[396]. The better approach would be to ask whether the directors have done anything improper[397]. It was therefore concluded that there does not exist a "proper purposes" doctrine as such[398].

Even after *Teck*, the jurisdiction concerning the behaviour of directors remained unsettled in Canada. Some courts applied the approach followed in *Teck*, whereas others rejected it[399].

Re Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.[400] followed the ratio set out in *Teck*, and established that it represents the law of Ontario[401]. In that case, the court considered the actions of the directors of Hiram Walker aimed at defeating a takeover bid from Gulf Canada Corporation to be legitimate, since their only purpose was

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394 *Ibid.* at 835.
395 Baxter, *supra* note 178 at 82.
396 Welling, *supra* note 381 at 352.
397 *Ibid.* at 353.
398 *Ibid.* at 355.
399 Kwaw, *supra* note 379 at 39.
400 *Hiram Walker*, *supra* note 381.
401 *Ibid.* at 271-272.

to attain the best possible return to shareholders[402]. Emphasis was also placed on the fact that the majority of the directors were outside directors[403].

Conversely, *Teck* was rejected by the Nova Scotia Supreme Court in *Exco Corp. v. Nova Scotia Savings & Loan Co.*[404]. The decision stated that the only principle which could be derived from the generally very inconsistent Anglo-Canadian jurisdiction on the proper purpose rule was that any action which was driven by self-interest and harmful of other interests is likely to be held illegitimate, especially in the context of the issuance of shares by directors[405].

The principle established in *Exco* is the following: The considerations upon which the directors based their decision to issue shares have to be "consistent only with the best interests of the company and inconsistent with any other interests"[406]. The burden of proof to demonstrate this lies on the directors[407]. This distribution of the burden of proof has been reaffirmed later in *347883 Alberta Ltd. v. Producers Pipelines Inc.*[408].

The case was interpreted as a step back to the proper purpose doctrine[409]. It also shook the previous assumption that *Teck* represented the state of the law concerning takeovers in Canada, or at least a general direction[410]. As a whole, the law in Canada seems to be as unsettled now as it ever was.

Nevertheless, there can be observed a tendency in Canada to reject the strict proper purpose rule rather than turn to it. Many of the later decisions are still based on the primary purpose of the actions of the management, but without limiting the possible purposes other than to the best interests of the company. This approach takes into account

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402 *Ibid.* at 272.
403 *Ibid.* at 257; see also Baxter, *supra* note 178 at 84.
404 *Exco Corp. v. Nova Scotia Savings & Loan Co,.* [1987] A.C.W.S.J. LEXIS 35966 [hereinafter *Exco*].
405 *Ibid.* at 195.
406 *Ibid.* at 207.
407 *Ibid.* at 207.
408 *347883 Alberta Ltd. v. Producers Pipelines Inc.* (Sask. C.A.), [1991] 80 D.L.R. (4th) 359 [hereinafter *347883 Alberta Ltd.*] at 407.
409 Baxter, *supra* note 178 at 85.
410 *Ibid.* at 87.

the intentions and good faith of the management[411]. This has been confirmed recently, since it has been stated in several cases that the actions of the management should be looked at in the light of the special circumstances, and the decisions should be made in good faith after a reasonable analysis and on a rational basis[412].

In the end, there is not much distinction between the two approaches in Canada and the US. If the primary purpose of an action a director took is to remain in office, then a court would find under the modified business judgement rule that the target directors did not have reasonable grounds to believe that there was a danger to the corporate policy[413]. As in their application and finding of results, the modified business judgement rule can be seen as more favourable, since it is harder to assess the primary purpose of a director in his actions. In any case, the burden of proof should always lie on the directors, not on the plaintiffs[414].

There do however, remain some differences. Other than in the US, where it is established in *Revlon* that the directors have to maximize shareholder value by conducting an auction as soon as the company is put up for sale, directors in Canada have been found not to have such a duty[415]. They should seek the best value reasonably available to the shareholders, which does not, however, limit the considerations of the directors only to the consideration offered[416].

c) Securities regulation

Securities legislation falls within the ambit of provincial regulation and the securities legislation of Ontario takes the leading role due to the dominance of the Toronto Stock Exchange[417]. Canada has several stock exchanges, which are regulated by the securities

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[411] Farrar, *supra* note 319 at 38.
[412] See e.g. *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*, [1998] 39 O.R. (3d) 755 at 768f.
[413] Baxter, *supra* note 178 at 76.
[414] *Ibid.* at 76.
[415] R. A. Shaw, "Hostile Bids: Defensive Strategies" (2000) 38 Alberta L. Rev. 111 at 117.
[416] See Shaw, *ibid.* at 118; *Maple Leaf Foods Inc. v. Schneider Corp.*, [1999] 42 O.R. (3d) 177 at 200.
[417] DeMott, *supra* note 269 at 399.

administrators in the provinces in which they are located[418]. The securities legislation and the regulations by the securities administrators are established independently from each other[419], but sometimes the securities administrators act in accordance, as may be evinced by the establishment of the National Policy 62-202 concerning the regulation of hostile takeovers, which has been adopted by all relevant securities administrators, and which will be treated in detail below[420].

The provincial securities laws also contain provisions about takeover bids, which do generally not include the regulation of defensive measures[421]. It is simply established that the directors have to issue a directors' circular within ten days after the bid, which has to contain their recommendations whether to accept the bid, and the reasons for their recommendation[422].

The securities administrators, however, impose additional rules on listed companies concerning certain aspects of hostile takeover regulation, including defensive measures, and in that context are involved in most disputes concerning takeover bids in Canada[423].

(1) Shareholder rights plans under the rules of the Toronto Stock Exchange

The Toronto Stock Exchange („TSE") has established certain requirements for listed companies concerning the validity of shareholder rights plans. Due to its practical importance, and the fact that it seems more developed in many respects than Canadian case law, the regulation and practice of the treatment of defensive measures, in particular shareholder rights plans, by the TSE are worth addressing.

The TSE requires that shareholder rights plans have to be approved by the shareholders within six months of their implementation[424]. If the majority of the shareholders do not

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[418] *Ibid.*
[419] *Ibid.*
[420] See E.III.2.c)(2).
[421] DeMott, *supra* note 269 at 413.
[422] Shaw, *supra* note 415 at 126; see *Ontario Securities Act (OSA)*, R.S.O. 1990, c. S.5, s. 99.
[423] "Shareholder Rights Plans", *supra* note 183 at 147.

vote in favour, the plan has to be cancelled, and any rights issued under it have to be redeemed[425].

Until the mid-1990s, shareholders usually voted in favour of these proposals, but due to the activism of institutional investors, they have become more critical. Provisions restricting the ability of the shareholders to sell their shares to a hostile bidder have been increasingly opposed[426].

The effect of the intervention of securities regulators in Canada, especially the TSE, is that shareholders rights plans are not as powerful as a defensive mechanism in Canada as in the US[427].

(2) National Policy 62-202

In 1986, the Canadian Securities Administrators created National Policy 38 about defensive tactics in takeover bids, which was initiated by the Ontario Securities Commission[428]. In 1997, it was replaced by National Policy 62-202, which did not make material substantive changes, and which is adopted now in the jurisdictions represented by the CSA[429].

In the light of the Policy, the Canadian securities regulatory authorities assess defensive measures as to whether they restrict the ability of shareholders to respond to a takeover bid, and if they do, they will take appropriate action[430].

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[424] *Toronto Stock Exchange Company Manual* (2002) s. 635 (a).
[425] *Ibid.*
[426] "Shareholder Rights Plans", *supra* note 183 at 144.
[427] *Ibid.*
[428] S. M. Beck & R. Wildeboer, "National Policy 38 as a Regulator of Defensive Tactics", in *Meredith Memorial Lectures, Faculty of Law, McGill University, Acquisitions and Takeovers* (Cowansville, Québec: Les Editions Yvon Blais Inc., 1987) 119 at 121.
[429] Ontario Securities Commission, *Note of National Policy 62-202 and Rescission of National Policy Statement No.38, Takeover bids – Defensive Tactics*, <http://www.osc.gov.ca/en/Regulation/Rulemaking/Policies/62-202_FNP_txt.html> [hereinafter "Note of National Policy"].
[430] "Note of National Policy", *supra* note 429.

The Policy is created on the basis that the regulatory authorities acknowledge that takeovers play an important role as a disciplining device for corporate managers as well as a means of efficiently reallocating economic resources[431]. Its objectives are the protection of the bona fide interests of the shareholders and the provision of an open and even-handed environment for takeovers, which leaves to the shareholders the opportunity to make a fully informed decision about whether to accept a bid or not[432]. In many ways, the Policy shows influences derived from the City Code on Takeovers and Mergers.

The Policy is not supposed to be a binding code of conduct. In the end, it remains in the hands of the securities administrators to decide whether a defensive tactic was abusive of shareholder rights and that they are deprived to respond to a takeover bid, since like this, they remain flexible in special cases, and the rules cannot be evaded[433].

However, there are several actions which indicate that shareholder rights might be affected, if they are taken after the directors have reasons to believe that a bid might be imminent. These include the issuance or purchase of securities, the sale or acquisition of assets of a material amount, as well as entering into a contract or taking corporate action other than in the ordinary course of business[434]. If the shareholders approve of an action in advance, it indicates that shareholder rights are not being abused[435]. Unrestricted auctions are generally encouraged by the securities administrators[436], since this normally leads to higher premiums for the target shareholders and to the takeover by a bidder which values the company the most[437].

As a whole, therefore, the Policy restricts the role of the directors to giving advice to the shareholders concerning the bid and to seek alternative offers. Defensive measures are generally allowed to trigger an auction[438]. This, however, implies the risk that they might

[431] *National Policy 62-202*, Part 1, 1.1 (1).
[432] *National Policy 62-202*, Part 1, 1.1 (2).
[433] *National Policy 62-202*, Part 1, 1.1 (3), (5).
[434] *National Policy 62-202*, Part 1, 1.1 (4).
[435] *National Policy 62-202*, Part 1, 1.1 (3).
[436] *National Policy 62-202*, Part 1, 1.1 (5).
[437] Beck & Wildeboer, *supra* note 428 at 130.
[438] *Ibid.* at 131.

eventually deter any bidder. Admitting defensive measures in certain circumstances might be advantageous, but at the same time bear the danger of abuse or failure. Therefore, in future, the management's use of defensive tactics might have to be more restricted, if the practice of permitting defensive measures to initiate auctions ultimately proves to be detrimental to shareholder interests[439].

Otherwise, the Policy declined to give specific rules as to what actions the management may take or not, since they might have positive or negative effects[440]. Further, in this way it is harder to evade them[441]. The Policy is restricted to post-bid defensive tactics, even though it has been suggested to extend it to pre-bid defensive tactics[442].

Accordingly, the securities administrators, among others the Ontario Securities Commission, generally apply the following principles in assessing a shareholder rights plan: A shareholder rights plan should not hinder the shareholders in the exercise of their right to sell their shares. If they have given their approval, it indicates that this is not the case, and the OSC will generally not interfere, unless it is clearly likely to harm the interests of the shareholders[443]. This is especially the cases when the ability of the shareholders to respond to a bid is severely limited[444].

(3) The relationship between the TSE rules and National Policy 62-202

The securities commissions are responsible for the review of defensive tactics under National Policy 62-202 after a hostile bid has been made. This is also true for the assessment of a shareholder rights plan which has been established subsequent to a hostile bid being made. According to s. 633 (b) of the *Toronto Stock Exchange Company Manual*, in such a scenario, the TSE will await the decision of the OSC regarding whether it ought to intervene under the National Policy, before exercising its own judgement.

[439] *Ibid.* at 132.
[440] *Ibid.* at 134.
[441] *Ibid.* at 135.
[442] *Ibid.* at 137.
[443] "Shareholder Rights Plans", *supra* note 183 at 146.
[444] *Ibid.* at 149.

d) The conflict between corporate law and securities regulation

The different approaches to regulating defensive measures in Canada shows clearly the position of the subject as on the borderline between securities law and corporate law, even though defensive measures are traditionally assigned to corporate law.

The first question is therefore to what extent the OSC and other securities administrators get the authority to decide about this. This will be elaborated by the example of the OSC. The OSA provides the OSC with a general discretion to order sanctions on transactions if it is, in its opinion, in the public interest[445]. This discretion is not designed to be unlimited, but it lies in the principal responsibility of the OSC to determine its scope[446]. It made this clear in *Re Canadian Tire Corporation Ltd.*[447], where it stated that it will sanction abusive transactions contradicting its public interest mandate, even if they just apply to the relations between management and the shareholders, which might otherwise be thought to be a matter for corporate law[448]. Theoretically, the decisions of the OSC can be appealed in front of the courts[449]. They, however, normally only intervene if the OSC abuses its power. Also, practical considerations deter the possibility of appeals, such as the maintenance of a good relationship with the securities administrators, the long time of appeals and the doubt regarding whether it would really constitute a success[450]. Therefore, the OSC has a broad flexibility to regulate corporate law matters. Concerning the regulation of defensive measures, the OSC is even, after recent amendments, expressly entitled to set up rules[451].

The question is now, whether the different authorities, which are basically the courts and the securities administrators, interact with each other in setting up their rules, which would be the condition for the establishment of a consistent harmonized regulation in Canada.

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[445] *OSA*, R.S.O. 1990, c. S.5, s. 127 (1).
[446] Moyer, *supra* note 196 at 57.
[447] *Re Canadian Tire Corporation Ltd.* (1987), 10 O.S.C.B. 858.
[448] Moyer, *supra* note 196 at 62.
[449] *OSA*, R.S.O. 1990, c. S.5, s. 9 (1).
[450] Moyer, *supra* note 196 at 63f.

In respect of National Policy 62-202, it has been criticized as inconsistent with the fiduciary duties expressed in corporate law. The CSA replied that this does not necessarily have to be the case, and that, in any case, the primary purpose of the Policy is its mandate to protect the functionality and efficiency of the Canadian capital markets[452]. This demonstrates that the priority for the securities administrators is to fulfill their aims, while the compliance with general corporate law standards is only of secondary importance[453].

On the other hand, in the first case in which a Canadian court had to assess a shareholder rights plan, *347883 Alberta Ltd. v. Producers Pipelines Inc.*[454], the Saskatchewan Court of Appeal stated that the courts should apply the principles set out in the National Policy 62-202 to determine the directors' powers to use defensive measures in the course of a hostile bid[455]. The court also placed emphasis on the fact that a defensive measure should, if possible, be approved or subsequently ratified by the shareholders[456].

This, however, has been criticized with the reasoning that the national policy never was considered to become legislation[457], and that it therefore does not seem suitable to act as an interpretational guideline to a corporate law provision enacted by the legislature[458], even though it has been acknowledged that it was necessary to align the so far inconsistent company law and securities legislation, and that the decision was trying to enable a co-habitation between the two[459].

This attempt clearly shows the difficulties of unifying both areas of regulation, not only concerning their objectives, but also in the way this is achieved. The intrusion of the

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451 *Ibid.* at 60; *OSA*, R.S.O. 1990, c. S.5, s. 143 (1) 28 (vi).
452 "Note of National Policy", *supra* note 429.
453 Moyer, *supra* note 196 at 61.
454 *347883 Alberta Ltd.*, *supra* note 408.
455 *Ibid.* at 401.
456 *Ibid.* at 402.
457 The Supreme Court of Canada stated that the Policies of the Securities Commissions do not have the status of law, *Pezim v. British Columbia (Superintendent of Brokers)*, [1994] 2 S.C.R. 557 at 596.
458 R. Yalden, "Controlling the Use and Abuse of Poison Pills in Canada: 347883 Alberta Ltd. v. Producers Pipelines Inc." (1992) 37 McGill L. J. 887 at 906.
459 Yalden, *supra* note 458 at 906, 912.

principles established by the securities legislation into the arena of defining the scope of fiduciary duties in the context of a hostile takeover, however, might not be the best approach. While it acknowledges that a regulation established by the securities administrators in many ways also meets the objectives of corporate law, it ultimately neglects the advantages of a dispute resolution process administered by the securities regulators. In general, it is better to leave the regulation and the governing procedures with one authority, while still trying to harmonize it with the approach of the other area of law. This does also not lead to a confusion of competences.

e) Stakeholders' interests

Case law establishes that the directors have the right to consider the interests of the employees or the community when assessing what is in the best interests of the corporation[460]. However, it has been stated that the interests of the shareholder should remain paramount[461]. There are no constituency statutes in Canada as there are in the US[462].

On the other hand, National Policy 62-202 determines that the management should not interfere with the ability of the shareholders to decide whether to accept a bid or not. The Policy explicitly rejects allowing other interests than those of the shareholders with the argument that it would be too difficult to assess the proper behaviour of the directors against such a wide-reaching standard, and this would provide the directors with too many means of justifying a defence. It acknowledges that these interests need to be considered, but leaves it to the arena of specialized legislation[463].

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[460] *Teck, supra* note 384 at 314.
[461] "Shareholder Rights Plans", *supra* note 183 at 147.
[462] Kuras, *supra* note 62 at 314.
[463] Beck & Wildeboer, *supra* note 428 at 124.

3. Conclusion and Outlook

The different, partly overlapping approaches in Canada have several negative impacts: Firstly, legal certainty is diminished, since one cannot always be sure of which rules to follow. Secondly, if the development of the takeover regulation is not centralized, it is unlikely that a solution will be found which will take into account all objectives and interests[464]. Finally, directors risk attempting to comply with one regulation and falling foul of the other[465]. It is consequently desirable to have a unification of the rules, or at the very least, greater unison in their approach.

There are several routes to take in attempting to do so. On the one hand, a harmonization and centralization of the regulations concerning hostile takeovers in the hands of the securities administrators could be sought. This would lead to an out-of-court dispute resolution, similar to the one applied under the City Code on Takeovers and Mergers[466]. The courts should only be required to step in as an appeal panel. Alternatively, a regulation via the corporate statutes and the court interpretation of the duties of the management could be established. This, however, would normally involve increased litigation, which is time-consuming and costly[467]. From the point of view that it addresses core corporate matters such as fiduciary duties, this has been seen as an advantage since litigation involves a higher level of fact-finding[468]. In the context of hostile takeovers, however, the situation is different, since the highly time-sensitive transactions require fast decisions. In that case, a regulation via the securities administrators is always preferable.

A less preferable, but adequate solution would be the approach taken in *347883 Alberta Ltd.*, which includes the principles established by the securities administrators into the jurisdiction. That would still involve more litigation, but at least lead to a harmonization and the application of rules which do not hinder takeovers and respect shareholder rights the most. However, a clear distribution of competence in that field would be favourable.

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[464] Moyer, *supra* note 196 at 69.
[465] Beck & Wildeboer, *supra* note 428 at 133.
[466] Moyer, *supra* note 196 at 71.
[467] *Ibid.* at 71-74.

It has been emphasized that not only do the regulations within Canada have to be harmonized, but also as between Canada and its major trading partners[469]. One of them, evidently, is the United States. There is however the question of whether harmonization is the main objective, or if it is to find the most favourable economic solution. Since Canada does not have to keep the regulations on a provincial level, it is not as susceptible to single-sided forces as the US, and can therefore base its considerations on economic and legal factors, and what is best for the economy as a whole.

[468] *Ibid.* at 74.
[469] "Discussion Paper", *supra* note 370 at 5.

F. RECENT DEVELOPMENTS IN TAKEOVER REGULATION

I. The development of a European Directive

1. The EU - a union of different political and economic systems

The economic landscape of Europe presents itself as very diversified, which is not surprising, given the variety of cultures and economic structures. Corporate governance systems in Europe range from the Anglo-American to the German and the Latinist model[470]. Until the 1970s, the economies and their corporate governance systems developed independently and individually under the influence of their distinct national characteristics[471], even though common political and historical roots and mutual relationships fostered the occurrence of similar rules[472]. Nevertheless, there are still considerable variations. Additionally, the stage of development of the capital markets widely differs[473]. This leads to a European model characterized by difference rather than similarity in the field of hostile takeovers. This is also illustrated by the frequency of hostile takeovers in the last decade. Whereas one has observed a high takeover rate in the UK, other countries, such as Germany, first experienced serious hostile takeovers only in the late 1990s. Against this background, the development of common EU regulation does not present an easy task.

[470] T. Baums, *Corporate Governance Systems in Europe – Differences and Tendencies of Convergence – Crafoord Lecture* (Osnabrück: Universität Osnabrück, 1996) [hereinafter "Corporate Governance Systems"] at 2.
[471] *Ibid.*
[472] *Ibid.* at 3.
[473] Bericht der Hochrangigen Gruppe von Experten auf dem Gebiet des Gesellschaftsrechts über die Abwicklung von Übernahmeangeboten vom 10.1.2002

2. The development and failure of a European Directive on hostile takeovers

a) The incentive to create a Directive and the subsequent debate

In 1985, the Commission announced that it intended to create a European Directive on the regulation of hostile takeovers, the 13th Directive on Company Law, after first proposing to do so in 1974[474]. It presented its first proposal to the Council and the European Parliament in 1989, which it amended in 1990. This draft, however, was widely criticized by the member countries for being too all encompassing, thus contradicting the EU's underlying principle of subsidiarity[475]. Moreover, many countries doubted the necessity and the practicability of a harmonized takeover law[476].

After questioning the member states regarding their suggestions for a new draft, the Commission presented a new model for a Directive in February 1996, which this time had the form of a skeleton directive, which left the member states sufficient flexibility for the detailed translation of the regulation. In 1997, the proposal was amended by the European Parliament. By June 2000, the members of the Council had reached an agreement on the likely form[477]. This agreement was presented to the European Parliament, which suggested several amendments, among others concerning the question of the regulation of defensive measures, in December 2000. These amendments, however, were not accepted by the Council and the Commission, so consequently they were made subject to a mediation process. The result was a new draft of the 13th Directive. This version failed to obtain a majority in the session of the European Parliament on July 4, 2001, where 273 members voted for and 273 members voted against the draft[478].

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http://europa.eu.int/comm/internal_market/en/company/company/news/hlg01-2002_de.pdf [hereinafter „Expertenbericht"] at 25.

[474] Merkt, *supra* note 16 at 227.

[475] See Art.5 of the Treaty establishing the European Community; T. Baums, *Zur Harmonisierung des Rechts der Unternehmensübernahmen in der EG*, (Osnabrück: Universität Osnabrück, 1995) [hereinafter „Zur Harmonisierung"] at 7, 9.

[476] „Expertenbericht", *supra* note 473 at 16.

[477] *Ibid.* at 17.

[478] „Expertenbericht", *supra* note 473 at 17f.

b) The draft of the 13th Directive as at June 2001

Even though the 13th Directive in the form as it was developed in the mediation process was finally rejected, it still constituted the basis for the discussions on further proceedings, especially concerning the treatment of defensive measures. Its general provisions and principles as well as its regulation of the behaviour of the target management will be outlined below.

(1) General provisions

The main objective of the Directive is to protect the interests of the shareholder. The preliminary discussions came to the conclusion that a thorough protection could only be provided by a EU-wide harmonized regulation, especially in the context of international takeovers[479].

Since the 13th Directive is only aimed at providing a skeleton regime, its regulations are not very detailed and leave room for the countries to consider their national legal and cultural characteristics. They have to have regard to its minimum requirements, but are entitled to enact stricter regulation[480]. The Directive has to be transposed into a national regulation within 4 years of it coming into force. In respect of the behaviour of the target company's management, the member countries have 5 years time to enact it[481]. According to the directive, the national regulations do not necessarily have to take the form of binding law, but can also be contained in administrative provisions or codes of practice[482], as long as their compliance is supervised by a public or private body, which is empowered by law or a public authority[483]. These provisions enable, for example, the United Kingdom to retain the City Code on Takeovers and Mergers in its self-regulatory

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[479] Richtlinie des Europäischen Parlaments und des Rates auf dem Gebiet des Gesellschaftsrechts betreffend Übernahmeangebote: Gemeinsamer Entwurf nach Billigung durch den Vermittlungsausschuss am 6. Juni 2001 [hereinafter "Directive"], Introduction.
[480] See "Directive", *supra* note 479, Article 3 (2) B.
[481] "Directive", *supra* note 479, Article 15 (1).
[482] "Directive", *supra* note 479, Article 1 (1).
[483] "Directive", *supra* note 479, Article 4 (1).

form[484]. Additionally, it remains in the power of the member states to assign the dispute resolution under the regulation to a court or other authority[485]. The member states can regulate whether, and under what conditions the parties can initiate administrative or judicial proceedings[486]. It should however be emphasized that the decisions of the supervisory authority should be capable of control by an independent court or tribunal[487]. In addition, the Directive enables the supervisory authorities to grant exceptions to the rules on condition that the general principles are followed[488]. This is another influence derived from the City Code.

The Directive covers the regulation of the offer as well as the behaviour of the target's management. Its principles include the equality of treatment of the shareholders, the provision of sufficient information as well as the duty of the management of the target company to act in the interests of the whole company[489]. In respect of the offer, the requirements of the Directive include, among others, the duty to make a mandatory offer if a party effectively acquires control of a company[490] and a minimum period of 2 weeks to accept an offer[491].

(2) The proposed regulation of defensive measures

Since one of the aims of the Directive was to increase the competitiveness of European companies in an increasingly globalised economy, it focuses on facilitating hostile takeovers[492]. This aim corresponds with the protection of shareholder rights. Therefore, the Directive establishes that the management must not engage into frustrating actions depriving the shareholders of the possibility to accept a hostile bid.

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[484] B. Clarke, "European Takeover Regulation – The Latest Draft of the 13th Company Law Directive" (1999) European Bus. L. Rev. 482 at 484.
[485] "Directive", *supra* note 479, Article 4 (6).
[486] "Directive", *supra* note 479, Article 4 (6).
[487] Clarke, *supra* note 484 at 486.
[488] "Directive", *supra* note 479, Article 4 (5).
[489] See "Directive", *supra* note 479, Article 3 (1) a) to c).
[490] "Directive", *supra* note 479, Article 5; The Directive gives no percentage to define „control"; this is left to the member countries.
[491] "Directive", *supra* note 479, Article 7a.
[492] Gilson, *supra* note 87 at 177.

According to Article 9 of the draft, the member states have to adapt the following standards: After the publication of a hostile offer, the management has to obtain the permission of a shareholders' meeting in advance of taking defensive measures. This is especially the case for the issuance of shares which result in permanently preventing the bidder from gaining control of the company. One exception is the search for a white knight, which the management can do without the permission of the shareholders[493]. To facilitate this procedure, the member states can define a shorter period than usual for the announcement of a shareholders' meeting, which has to be at minimum two weeks[494]. Apart from that, the member states can permit the management to raise the capital of the company if the shareholders have given their approval to do so not more than 18 months in advance, and the owners of the old shares keep their assigned right to purchase the new shares[495]. Additionally, the management has to give a reasoned statement concerning the offer, which must also be communicated to the employees to the company[496].

That provision was clearly influenced by the fundamental principle of the neutrality of management prescribed in the British City Code on Takeovers and Mergers[497], which served in many ways as a model to the new regulation. Nevertheless, the planned regulation of managerial behaviour came under fire from the British Government, which wanted to abolish the possibility of the permission to raise capital so far in advance[498]. Additionally, it opposed any further attempts to loosen the duty of neutrality[499].

Conversely, Germany favoured a regulation which allowed the target management more flexibility[500]. Its argument was principally that European companies would be rendered easy takeover targets in relation to their US counterparts where the companies have greater opportunity to defend themselves against hostile takeovers[501]. Another objection put forward was that other countries in the EU had multiple, maximum or golden voting

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[493] "Directive", *supra* note 479, Article 9 (1) a).
[494] "Directive", *supra* note 479, Article 9 (1) c).
[495] "Directive", *supra* note 479, Article 9 (2).
[496] "Directive", *supra* note 479, Article 9 (1) d).
[497] Merkt, *supra* note 16 at 228.
[498] „Verhaltenspflichten", *supra* note 19 at 1364.
[499] Merkt, *supra* note 16 at 232.
[500] „Verhaltenspflichten", *supra* note 19 at 1364.

shares, which would put German companies at a disadvantage if they could not defend themselves in another manner, since it was decided to abandon such shares not long ago[502].

On the whole, however, most countries agreed with the basic concept of the neutrality of the management[503].

(3) The time frame for the application of the proposed regulation

Pre-bid defensive measures are not regulated in the draft of the 13th directive, since its regulation only applies after the announcement of the decision to make an offer[504]. The member countries can choose an earlier moment, for example when the management finds out that an offer is imminent[505]. Otherwise, the Directive determines that if a decision was made prior to any knowledge of an offer, and was not entirely realized at the time of the offer, the shareholders have to approve of it if it was not in the course of the ordinary business and if it could lead to the frustration of the offer[506].

However, some regulations concerning pre-bid defensive measures were to be found in the Commission's Proposal for a Regulation on the Statute for a European Company[507]. Poison pills in the form taken in the US could, as a pre-bid measure, theoretically be permitted, but the issuance of securities after the bid would require shareholder approval, so that the plan in fact could not be executed[508].

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[501] H.-W. Neye, „Die EU-Übernahmerichtlinie auf der Zielgeraden“ (2001) ZIP 1120 at 1122.
[502] *Ibid.*
[503] H. Altmeppen, „Neutralitätspflicht und Pflichtangebot nach dem neuen Übernahmerecht“ (2001) ZIP 1073 at 1074.
[504] "Directive", *supra* note 479, Article 9 (1) a), Article 6 (1).
[505] "Directive", *supra* note 479, Article 9 (1) a).
[506] "Directive", *supra* note 479, Article 9 (1) b).
[507] Gilson, *supra* note 87 at 176.
[508] "Directive", *supra* note 479, Article 8 (1) (a); Gilson, *supra* note 87 at 176.

(4) Stakeholders' interests

The provision in Article 9 (1) of the Directive not to frustrate an offer and therefore not to interfere with the ability of the shareholders to sell their shares to a hostile bidder is clearly aimed to ensure that the management acts primarily in the interests of the shareholders. On the other hand, the General Principles stated in Article 3 require that the management acts in the interests of the company[509]. The question is how the interests of the company are defined in that context, and whether they contain the interests of the employees as well. This has not been entirely clarified, even though there is a tendency in the interpretation of the Principle to include interests other than those of the shareholders, as is customary in several member states[510]. The question is whether Article 9 prevails as the superior provision, or whether Article 9 has to be interpreted in the light of the General Principles. The draft provides no clear resolution to this problem. It can be assumed, however, that Article 9 should be relevant in the event of conflicting interests. This is due to the fact that in the discussions surrounding the 13th Directive, there has been much emphasis on the issue of if and to what extent the management should be able to interfere with shareholders' rights. Indicatively, in the newly enacted German Takeover Law, a similar conflict exists, and it has been decided in favour of the specific provision[511]. Even though it did not follow the Directive anymore, this can be seen as a pointer of what the Directive intended to do.

The Directive further establishes that the employees are provided with sufficient information regarding the offer[512].

3. The advantages and disadvantages of harmonization by way of a European Directive

After the rejection of the draft as it was established in the mediation procedure, the merits of a creation of a European Directive, and the way it should regulate hostile takeovers,

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509 "Directive", *supra* note 479, Article 3 (1) c).
510 Krause, *supra* note 361 at 910f.
511 See F.II.3.f).
512 "Directive", *supra* note 479, Article 6.

especially defensive measures, were subject to new discussions. This section examines why and how the regulation of defensive measures should be harmonized.

One argument in favour of a need for harmonization would be the avoidance of competition between the member states, which would try to attract companies due to a management friendly hostile takeover regulation, such as it exists in the US among the states already[513]. However, due to the fact that in Europe the headquarters approach for the determination of the applicable law is prevalent in most countries (apart from especially the UK), whereas in the US the incorporation approach reigns, it would be more costly and time-consuming to change the legal regime by effectively moving the headquarters of a company, so that this strategy is less likely to succeed in Europe[514]. The mobility of companies including directors and employees is far lower in Europe than in the US, since there are such divergences between member states in culture and language[515]. In fact, there exist very few examples where governments were being driven by the aim of attracting foreign companies when enacting such laws[516]. Therefore, apart from the fact that competition does not necessarily have to be negative, but can also be positive, if it results in even more efficient regulations, this aspect does not have to be considered when assessing the needs of a harmonization in Europe.

Apart from the difficulties presented by differences such as in the economic and political structures as well as culture, which have to be overcome, harmonization can only be seen as positive. It facilitates the opening up of international capital markets, and therefore enhances the ability of companies to raise capital. In this way it creates a level playing field for the companies of all EU countries, which provides them - at least in this respect - with a similar level of competitiveness. The main question, however, is how such a harmonization should take form, and how extensive it ought to be.

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[513] Gilson, *supra* note 87 at 187.
[514] *Ibid.*; "Corporate Governance Systems", *supra* note 470 at 5.
[515] *Ibid.* at 6.
[516] *Ibid.* at 5, citing a few examples.

In creating a harmonized law of takeovers in the member states, the EU has the choice between several models already applied by different countries[517]. The existing regimes give a broad range of possibilities, with the German model on the one end and the British model on the other end[518]. Since the British model has proven to be the most successful in reaching the aims that the Directive is attempting to meet, it makes the most sense to follow its principles as much as possible while still leaving room to enable the other countries to retain parts of their national regime. Another possibility would be to introduce an entirely new model. This, however, might be even more difficult and not as successful as an already well-tested one. On the other hand, it has to be born in mind that future changes, especially due to the still increasing internationalization and progress in technology, might make it necessary also to adapt existing models which have been proven successful in the past, and therefore to leave room for later developments[519].

This, however, is the main disadvantage of a regulation via a Directive. Once enacted, it is hard to amend or repeal. This is due to the fact that the creation of a Directive requires negotiation and compromise which is time-consuming[520], as is evident from the 13th Directive, the first drafts having been made in 1989. Additionally, because of the centralization of the enactment process, and its practical irreversibility, the development of a more efficient regulation by any of the member states might be hindered[521].

On the other hand, a variable regime, as it was suggested[522], might be hard to realize, and might not lead to a sufficient level of harmonization to reach the desired goals. Further, it would lack the necessary degree of legal security.

As a whole therefore, harmonization in form of a Directive can still be regarded as the best means of achieving uniformity. The necessary degree of flexibility can be achieved by avoiding excessively detailed regulation, and by providing the local authorities with

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[517] Gilson, *supra* note 87 at 178.
[518] *Ibid.*
[519] *Ibid.* at 179.
[520] *Ibid.*; "Corporate Governance Systems", *supra* note 470 at 4.
[521] "Corporate Governance Systems", *ibid.*
[522] Gilson, *supra* note 87 at 180.

the power to make rulings in certain cases which can deviate from the precise regulations in the Directive, as was already foreseen in the last draft of the 13th directive.

The question is whether the Directive should only regulate the content as it was in the last draft, or whether it should extend its scope of regulation to other fields, such as structural defences in the form of special voting rights or complex shareholder structures. On the one hand, to really reach parity, however, it is necessary that these aspects are harmonized as well. On the other hand, an EU wide regulation of basic economic characteristics of a country might go too far in the framework of the 13th directive, especially since they would have much more significance, not only in the context of hostile takeovers, but also in other fields of the economy. Therefore, the scope of the regulation of the 13th Directive should be restricted to features which are typically or mainly used as defence mechanisms or could hinder the gain of control. This includes special voting rights and golden shares. These have played an important role in the rejection of the draft of the European Directive of June 2001. It is therefore inevitable that these subjects are treated in the European directive, or in another directive, as well, since only then can a level playing field among European companies can be achieved[523]. This might also be the only chance to reach an agreement on a new Directive among the member states.

Another issue is whether to take account of the US market. The argument that the US is a strong trading and business partner of European companies, and that they want to remain competitive and act on a level playing field in their home market as well as abroad, speaks strongly for the coordination of a harmonization on the EU level with existing US law[524]. On the other hand, the current regulation in the US does not match the practical needs of Europe, and is not even seen as ideal by US legal and economic literature. The reason for its current shape is due to political characteristics in the US, which are fundamentally different in Europe. Furthermore, the legal and capital market

[523] P. Hommelhoff & C.-H. Witt, „Bemerkungen zum Deutschen Übernahmegesetz nach dem Scheitern der Richtlinie“ (2001) RIW 561 at 569.
[524] See "Corporate Governance Systems", *supra* note 470 at 4.

environments differ substantially. In the US, for example, one can more easily bring an action against the management[525].

Concerning the argument, that if European companies have fewer opportunities to use defensive measures, the lack of uniformity would prove to be detrimental, the following can be said: First, the European companies would attract, rather than deter, foreign investors, which helps them refinancing themselves. Second, it is harder to finally gain control over a company and effect restructuring in many European countries than in the US. Therefore, they are provided a certain level of protection which might be lacking when defending themselves[526].

The issue is whether the need for a thorough harmonization is stronger than meeting the specific needs on a EU level. The answer in this case is probably no, since a mere adoption of US rules would do more harm than good, especially in light of national differences. The solution lies in a cooperation and coordination with the US, although this is unlikely in the near future. Nevertheless, in the course of the capital markets growing in tandem as a result of increasingly internationally focused investors, it is essential that capital markets eventually act in greater accordance[527].

4. A new attempt

The considerations made above are being largely reflected in the discussions about the future proceedings, which have not yet resulted in an agreement.

At the beginning of September 2001, the EU Commission established an international group of seven experts on the field of corporate law from different European countries to support the Commission on the work on a new Directive proposal concerning the

[525] „Expertenbericht“, *supra* note 473 at 47.
[526] Dimke & Heiser, *supra* note 66 at 259.
[527] *Ibid.* at 258.

regulation of hostile takeovers[528]. In January 2002, it published its report with its recommendations concerning the Directive.

Concerning the regulation of defensive measures, the group puts much emphasis on the positive effects of hostile takeovers as a disciplinary measure as well as a means to realize value-enhancing synergies[529]. It is of the opinion that the final decision about an offer has to be left with the shareholders, on the grounds that every participant of the capital markets should retain this right to ensure their efficient operation[530]. Therefore, the management should not take defensive measures without their approval. Due to the underlying conflicts of interests and the risks and costs for the shareholders, the group did not support the use of defensive measures to protect the interests of stakeholders. They were thought to be better served by other provisions, such as labour law[531].

The group rejected the argument that a Directive restricting the use of defensive measures would be flawed if at odds with the US model by being detrimental to European companies for reasons cited above[532]. If political constraints remain, the group suggests the restriction of the Directive to takeover bids of EU companies[533].

Accordingly, the group recommends keeping the original Article 9 of the last draft of the Directive[534]. It rejected the proposal to include a provision which enables the management to use defensive measures which have been approved by the shareholders up to 18 months in advance. The reasons for that are that the shareholders could not make a fully informed decision on the basis of the actual offer as well as the state of the company and the economic situation at the time of the offer[535].

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528 „Expertenbericht", *supra* note 473 at 80.
529 *Ibid.* at 3.
530 *Ibid.* at 22.
531 *Ibid.* at 3.
532 *Ibid.* at 8.
533 *Ibid.*
534 *Ibid.*
535 *Ibid.* at 31.

The approval of the shareholders should be made with a majority of the risk bearing capital, which excludes the possibility to restrict or enlarge the voting rights of one share in the decision. Additionally, the bidder should be able to vote as well[536].

The discussion about the new draft of the 13th Directive also addresses structural impediments against hostile takeovers in several EU countries, such as multiple voting rights, the restriction of voting rights as well as golden shares, which led to the abandonment of the first draft. The current trend is basically to keep these protective mechanisms, but in the concrete situation of a hostile takeover, these barriers should fall, and the principle should be "one share, one voice"[537]. It has also been recommended by the expert group that shares with restrictions on transfer ought to be capable of sale when faced with a bid[538].

After the publication of the report of the expert committee, the Commission intended to transfer its proposals into a new Directive[539]. This, however, has met a lot of opposition, particularly concerning the treatment of defensive measures and special voting rights. In consequence, the Commission is reconsidering the new draft, in the process of which it wants to consult the group of experts again. A new draft will not be presented before late September 2002, after the German federal elections[540].

Nevertheless, even though the 13th Directive did not come into force, it already had an effect: many member states enacted takeover regulations already in accordance with the EU Directive, including France, Italy, Austria, Sweden and Switzerland[541]. This was also due to the fact that it was mainly based on the City Code on Takeovers and Mergers, which has proven to be successful, and which is seen as a model. In this way, a considerable level of harmonization could already be achieved – with the big exception of Germany. It is very likely that a new draft might lead again to opposition from the

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[536] *Ibid.* at 9.
[537] C. Zschocke, „Europapolitische Mission: Das Neue Wertpapiererwerbs- und Übernahmegesetz" (2002) DB 79 at 85.
[538] „Expertenbericht", *supra* note 473 at 42.
[539] „Zweite Chance für EU-Übernahmerecht" *Financial Times Deutschland* (11/01/2002).
[540] „Übernahmerecht wird nachgebessert" *Handelsblatt* (9/7/2002).

German side, since it would have to change the Takeover Law, which has just been enacted in January 2002, and which is not in accordance with the regulations of the European Directive as it is planned so far[542].

II. Germany's new takeover statute

1. Political and economic background

Germany has a very short history of hostile takeovers. The biggest impediments to hostile takeovers in Germany have been the structural and political barriers.

One of the German characteristics which influences the success of hostile takeovers and the subsequent gain of control is the two-tier board structure consisting of the management of the company and the supervisory board, the latter of which is made up of 50 per cent shareholder representatives and 50 per cent employee representatives, with a shareholder representative usually being the chairman who has the deciding vote. Such a form is mandatory where a stock company exceeds 2000 employees[543].

The management is appointed for up to five years, and can only be removed before that period with special cause[544], unless it is provided otherwise in the company's articles. Prior to that, the new shareholder has to replace the former shareholder representatives on the supervisory board, which appoints and removes the members of the management. The shareholder representatives of the supervisory board are elected and recalled by the shareholder meeting[545], and their removal normally requires a 75 per cent vote by the voting shareholders[546]. Consequently, the acquisitor needs more than just 50 per cent of the shares to be sure of obtaining control. The question is whether the supervisory board, while constituting an impediment to hostile takeovers, can contemporaneously act as an

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[541] Krause, *supra* note 361 at 913.
[542] „Brüssel schont Bundesregierung und VW" *Süddeutsche Zeitung* (25/02/2002).

[543] §1 MitbestimmungsG.
[544] §84 I, III AktG.
[545] §101, 103 AktG.

efficient substitute for the external control provided by takeovers. The main power of the supervisory board is the ability to recall directors. Apart from that, its powers are restricted, and it has more an advising than a controlling function, even though the name suggests otherwise[547]. Moreover, it meets only a few times a year, and its members are usually members of other boards as well so they are not entirely involved in the business affairs of the company. The supervisory board cannot therefore be seen to act as a sufficient monitoring device on its own[548].

Another feature of the German economic structure is the dominance of financial institutions, whose ability to hold large blocks of shares is unrestricted. Here as well it might be argued that banks, which discourage hostile takeovers due to their large concentrated shareholdings, can compensate for this by exercising sufficient external control. Apart from their own shareholdings, banks gain their power from proxy votes, which means that their clients enable them to execute their voting rights, which are sometimes, but not always, combined with directions on voting[549]. Since many banks, who are often represented on supervisory boards as shareholder representatives, but are at the same time creditors of the companies, pursue their own interests, they are not seen as reliable, neutral monitors to safeguard the interests of all shareholders[550]. Furthermore, banks and other institutional investors, such as mutual funds, have fiduciary duties themselves towards their investors. These interests might clash with the ones of the other shareholders. Therefore, the presence of banks as large shareholders cannot be seen as an adequate substitute for an external control, and indeed, there may be a need in many cases to supervise the banks themselves due to their conflicts of interests[551].

The German corporate structure is also characterized by the slower development of the capital market relative to other major economies. Traditionally, many corporations used to finance themselves more through bank loans than capital markets.

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[546] §103 I AktG.
[547] "Some Differences", *supra* note 74 at 1942f.
[548] *Ibid.* at 1942.
[549] §135 AktG.
[550] Escher-Weingart, *supra* note 71 at 393.
[551] "Some Differences", *supra* note 74 at 1978.

However, the German corporate environment and attitudes which have been stable for many years are in the course of change. Private shareholding has become increasingly common. This is partly due to the changing image of shares as an investment possibility among the population, the privatization of large companies which used to attract small as well as institutional shareholders, the increasing number and acceptance of funds and the rising significance of private pension savings caused by an ageing population[552]. In addition, because of the growing importance of equity financing, as well as the rising pressure of international competition, capital markets have become more important[553].

Apart from that, large shareholdings, including the current web of cross-shareholdings, are to be dissolved as a result of changes to German tax law, which came into force in January 2002 and which diminishes the tax burden on gains realized by such sales[554]. Reform proposals in 1998, which were aimed at restricting the share ownership and influence of banks, however, were opposed and did not succeed[555]. In general, many of the traditional corporate structures, including family businesses with high shareholding concentration, are being broken up and restructured, leading to a more diversified ownership structure[556]. These changes will improve the conditions for hostile takeovers, which have occurred more frequently in recent years.

2. Former regulation of defensive measures

The former regulation of defensive measures in Germany establishes the starting point for the discussions and subsequent drafts of the new takeover law.

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[552] "Corporate Governance Systems", *supra* note 470 at 11.
[553] "Corporate Governance", *supra* note 79 at 806.
[554] Hommelhoff & Witt, *supra* note 523 at 566.
[555] "Corporate Governance", *supra* note 79 at 805.
[556] Bergstrom, Hogfeldt, Macey & Samuelsson, *supra* note 105 at 522.

a) General corporate law

In German corporate law the principle that it is only the management which is responsible for its actions[557] meets the principle of shareholder control[558]. It is the prevailing opinion, however, that in the end the shareholders as principals in the relationship, hold power, and that the management is obliged to act in their interests[559].

Before the creation of a special law on hostile takeovers, the majority of the German legal literature interpreted the general corporate law in the way that the management has a duty not to frustrate any hostile offers with various arguments[560]. First, the possibility for the management to influence the shareholder structure would contradict its function as the agent of the shareholders[561]. Second, the decision whether to accept an offer or not lies with the shareholders, and the management must not use the means of the company to interfere with that[562]. The management should only be entitled to defeat a hostile takeover if it results in illegality, or would be extremely detrimental to the company and its position in the market[563]. This, however, does not include the liquidation of the company or the loss of its independence, since those matters generally lie in the hands of the shareholders[564]. This principle has been followed in the first drafts of takeover regulation as well.

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[557] See §76 I AktG.
[558] "Corporate Governance", *supra* note 79 at 789.
[559] *Ibid.* at 789f.
[560] See e.g. Dimke & Heiser, *supra* note 66 at 242; Altmeppen, *supra* note 503 at 1080; „Verhaltenspflichten", *supra* note 19 at 1376.
[561] M. Winter & S. Harbarth, "Verhaltenspflichten von Vorstand und Aufsichtsrat der Zielgesellschaft bei feindlichen Übernahmeangeboten nach dem WpÜG" (2002) ZIP 1 at 2; „Verhaltenspflichten", *supra* note 19 at 1376.
[562] G. Maier-Reimer, „Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen" (2001) ZHR 258 at 260.
[563] *Ibid.* at 271f.
[564] K. J. Hopt, „Aktionärskreis und Vorstandsneutralität" (1993) ZGR 534 [hereinafter „Aktionärskreis"] at 550.

b) The Übernahmekodex

The Übernahmekodex ("Kodex") was established by the stock exchange expert commission in 1995, and supervised by a takeover commission. It contained recommendations for the proper conduct in the course of a hostile takeover, and did not have a binding character or result in legal sanctions. It was aimed at securing the provision of sufficient information to all participants as well as preventing abuse or misbehaviour[565]. Concerning the use of defensive measures, it stated that the management must not take any measures which could affect the ability of the shareholders to accept the offer[566].

Even though the principles of the Kodex were generally approved, it was not as widely accepted as the City Code on Takeovers and Mergers in the UK[567]. Even the inclusion of its acceptance in the terms for admission to some segments of the German stock exchange, such as the DAX, the Neuer Markt and the SMAX, appeared incapable of provoking its adoption[568].

3. The final statute: The Wertpapiererwerbs- und Übernahmegesetz („WpÜG")

a) The need to effect binding legislation

In response to the relative failure of German corporations to adhere to the Kodex, the stock exchange expert commission recommended the creation of a binding law in 1999[569]. In the aftermath of the successful hostile takeover of Mannesmann AG by Vodafone Group Plc of the United Kingdom, which was completed by the end of March

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565 Introduction to the Übernahmekodex („Kodex"), Börsensachverständigenkommission beim Bundesministerium der Finanzen, from 14/07/1995, amended on 01/01/1998.
566 Article 19 of the Kodex.
567 Until April 2001, only 755 of the 1016 companies listed on the Stock Exchange accepted the Kodex, see A. Möller & T. Pötzsch, "Das neue Übernahmerecht – Der Regierungsentwurf vom 11. Juli 2001" ZIP 1256 at 1256.
568 Zschocke, *supra* note 537 at 79.
569 See Börsensachverständigenkommission beim Bundesministerium der Finanzen, *Stellungnahme zum Diskussionsentwurf des Übernahmegesetzes vom 29.6.2000* (19/07/2000) at 1.

2000, the German government realized the need to enact a legally binding statute regulating hostile takeovers. In spring 2000, an expert commission was formed, including representatives of the economy, science, the unions and several ministries, which laid down ten principles for a new statute, the Wertpapiererwerbs- und Übernahmegesetz („WpÜG“), which have been considered in the first draft by the Ministry of Finance[570].

b) The content and the general principles

Concerning its area of regulation, the WpÜG has a similar content as the City Code on Takeovers and Mergers. It regulates both the manner of the offer as well as the behaviour of the target management. The main objectives of the WpÜG are to ensure a fair, regulated and speedy takeover process as well as the provision of sufficient information of the affected parties[571].

The requirements for the offer are relatively strict, as in the City Code on Takeovers and Mergers. This is evidenced by an offer period of four weeks[572], the prohibition of partial bids[573], and the fact that the offer has to be made under the same conditions for all shareholders[574], and that a mandatory offer is required if the bidder exceeds 30 per cent of share ownership[575].

Combined with the introduction of the WpÜG is the insertion of a squeeze-out rule into general corporate law, which determines that a shareholder owning at least 95 per cent of the shares has a right to pay out the remaining minority shareholders at a fair price.

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570 Möller & Pötzsch, *supra* note 567 at 1257.
571 T. Liebscher, „Das Übernahmeverfahren nach dem neuen Übernahmegesetz“ (2001) ZIP 853 at 854.
572 §16 I WpÜG.
573 §32 WpÜG.
574 §3 I WpÜG.
575 §§35, 29 II WpÜG.

c) The development of the regulation of defensive measures and the final version

The following overview shows how the treatment of defensive measures changed in the course of the discussions until the final statute was enacted. It demonstrates clearly the general attitude of the German Government, which substantially changed in the course of the development.

(1) The first draft ("Diskussionsentwurf")

In the first draft from June 2000 ("Diskussionsentwurf"), defensive measures were regulated in the following way[576]: After the publication of the decision of the bidder to launch a hostile offer, the management and the supervisory board must not act in a manner capable of frustrating the success of the offer. This duty is particularly broken in the following cases: the issue of shares, the acquisition of the company's own shares, as well as the entering into deals which could substantially change the assets or liabilities of the company. A breach of the duty does not include however, among others, the search for a white knight, actions on the basis of an approval of the shareholders' meeting, the pursuance of the current business in the interest of the company, and the fulfillment of contractual or other obligations which have been established before the publication of the offer.

(2) The second draft ("Referentenentwurf")

The regulation of defensive measures in the second draft of the WpÜG basically did not distinguish itself from the first draft, apart from a few minor differences in wording[577]. In the paragraph which addressed defensive measures it was added that the bidder is not permitted to make or promise the incumbent management any unjustified payments or

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[576] § 31 of the Diskussionsentwurf, Entwurf eines Gesetzes zur Regelung von Unternehmensübernahmen, Bundesministerium der Finanzen, from 29/06/2000.

[577] § 33 of the Referentenentwurf, Entwurf eines Gesetzes zur Regelung von Öffentlichen Angeboten zum Erwerb von Wertpapieren und von Unternehmensübernahmen, Bundesministerium der Finanzen, from 12/03/2002.

other contributions in relation with the offer. This, however, was already regulated in the first draft, but in a different paragraph.

Both the first and the second draft were in conformity with the then planned version of the 13th Directive[578], since otherwise the German statute would have had to face amendments in the near future.

(3) The third draft ("Regierungsentwurf")

The third draft distinguished itself substantially in its treatment of defensive measures from the first and second draft. This was possible since it did not have to take into consideration the prospective regulations of the 13th Directive anymore, which was rejected shortly before.

The new draft stated[579]: After the publication of the decision to make a hostile offer, actions of the management and supervisory board, which could frustrate the offer, need the approval of the shareholders' meeting. This is not necessary for actions which a considerate director of a company, which is not affected by an offer, would have taken. That means that actions in the ordinary course of business are allowed as well as actions in connection with previously chosen business strategies[580]. The same applies for the search for a white knight. The approval of the shareholders, which has to be given by at least three quarters of the present shareholders, needs to specify the allowed actions in detail, and can be given 18 months in advance. If the management takes a measure on the basis of such an approval, it has to get the permission of the supervisory board.

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[578] Altmeppen, *supra* note 503 at 1074.

[579] § 33 of the Regierungsentwurf, Entwurf eines Gesetzes zur Regelung von öffentlichen Angeboten zum Erwerb von Wertpapieren und Unternehmensübernahmen, from 11/07/2001.

[580] Möller & Pötzsch, *supra* note 567 at 1286.

(4) The final version

(a) The regulation

The final version of the WpÜG was approved on November 15, 2001 by the German parliament. Its treatment of defensive measures changed again due to the adoption of the recommendations of the finance committee of the German parliament[581]. The following modifications have been made: First, the management can take defensive measures, which lie within its powers upon obtaining the permission of the supervisory board, even if the shareholders' meeting did not give advance approval. The provision which required that the actions of both the management and the supervisory board be approved by the shareholders has been eliminated. Second, the previous approval of measures by the shareholders' meeting, which are part of its own competences assigned by corporate law, does not have to specify the concrete actions anymore, but only the kind of actions which the management is entitled to take. It is still possible for the shareholders to approve of certain measures after the occurrence of a firm offer[582]. The statute provides certain facilitations for the organization of a shareholder meeting in the context of a hostile takeover, such as a shortened time for the announcement of the meeting[583].

Apart from that, the management as well as the supervisory board have to make a statement in response to the offer[584]. Publicity is generally permitted, but can be restricted in certain cases if there is the danger of abuse[585].

Both the regulation in the WpÜG as well as the official statement make clear that the WpÜG does not intend to alter the duties and competences prescribed by general corporate law[586]. Nevertheless, the management might still have the authority to take defensive measures if it got the previous approval of the shareholders to take a certain

[581] § 33 WpÜG; see also Beschlussempfehlung und Bericht des Finanzausschusses (7. Ausschuss), Deutscher Bundestag, 14. Wahlperiode, Drucksache 14/7477, 14.11.2001, at 3 and 29f.
[582] Winter & Harbarth, *supra* note 561 at 13.
[583] §16 IV WpÜG.
[584] §27 WpÜG.
[585] §28 WpÜG.
[586] see § 33 WpÜG; Möller & Pötzsch, *supra* note 567 at 1265.

action in another context[587], which deprives the shareholders of specifically enumerating whether their permission was aimed at a general business action, or a measure to defeat a hostile takeover. This would, for example, be the case for some of the most efficient defensive measures permitted by German law, such as the increase of capital or the acquisition of the companies' own shares[588].

(b) Problems and criticism

This final regulation, as well as already the preceding regulation of the third draft, have been subject to much criticism.

Firstly, the deciding power of the supervisory board in cases which do not fall into the competence of the shareholders' meeting has been met with scepticism. Since the shareholder representatives on the supervisory board are elected by the majority of the shareholders, the interests of the minority shareholders might not be considered in the decisions of the supervisory board[589]. Apart from that, half of the supervisory board consists of employee representatives, who normally should not have the power to decide about the change of ownership[590]. In addition, the members of the supervisory board might have other self-interests, such as the banks which are contemporaneously creditors. Therefore, the supervisory board cannot exercise the same function as the independent directors in the UK or the US[591], especially in the context of a hostile takeover.

The second point of criticism is the possibility for the shareholders' meeting to approve of a certain kind of defensive measures in advance, since like this the shareholders are deprived of the possibility to decide on an entirely informed basis due to the lack of a concrete offer[592]. Also, this might lead to the paradoxical result that the shareholders can decide about concrete measures which already require their approval due to general corporate law outside the course of a hostile bid, whereas they might not have this

[587] Beschlussempfehlung und Bericht des Finanzausschusses, *supra* note 581 at 74.
[588] Winter & Harbarth, *supra* note 561 at 9.
[589] Zschocke, *supra* note 537 at 82.
[590] Zschocke, *supra* note 537 at 82.
[591] „Verhaltenspflichten", *supra* note 19 at 1378.
[592] Zschocke, *supra* note 537 at 83; see D.II.2.b)(3).

possibility anymore after the announcement of a hostile offer[593]. The question is how much practical significance this provision might have. It can be assumed that such a permission would lead to a lower share price[594]. Additionally, the possibility of using defensive measures which have been approved in advance by the shareholders in another context just with the permission of the supervisory board might already cover many possible actions.

Thirdly, it was argued that the provision that the management can take actions which a considerate director of a company which is not subject to a takeover offer would have taken, might lead to a curious result: The management could take measures in the extraordinary course of business if it is in the pursuance of a certain strategy, and the standard applied to it would just be the ordinary standard applied to all business decisions of a management which is not in the situation of a hostile takeover and therefore not in a possible conflict of interests[595]. This standard just tests whether the management significantly exceeded the limits of a responsible leadership of a company or whether irresponsible risks were entered into[596].

Therefore, the only way to avoid this result is to attach high standards to the determination of whether an action is taken in the ordinary course of business or in pursuance of a previously chosen strategy, and to apply an even higher standard in questionable cases.

d) The time frame in which the WpÜG applies

The regulation of the WpÜG steps in after the publication of the decision to make an offer[597]. There is no provision such as that contained in the City Code on Takeovers and

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[593] R. Thaeter, "Zur Abwehr feindlicher Übernahmeversuche im RegE eines Gesetzes zur Regelung von öffentlichen Angeboten zum Erwerb von Wertpapieren und von Unternehmensübernahmen (WÜG-RegE)" (2001) NZG 789 at 790.
[594] Winter & Harbarth, *supra* note 561 at 13.
[595] Drygala, *supra* note 160 at 1865f.
[596] Drygala, *supra* note 160 at 1865.
[597] §33 WpÜG.

Mergers which also applies if the management already has reasonable grounds to believe that an offer will be made.

However, defensive measures which are taken in advance and are capable of completely precluding any offer in advance violate the managerial duty of care prescribed in corporate law[598]. Many pre-bid defensive measures will be restricted by general corporate law, or made subject to the approval of the shareholders.

e) The relationship between the WpÜG and general corporate law

The basic principle is that the more specific law, in this case the WpÜG, super-cedes the more general corporate law[599]. This is independent from the classification of the WpÜG as corporate or capital market law. In the end, as it was stated above, it concerns both areas of law, and can therefore affect the regulations of both of them in the special context of hostile takeovers[600]. This only happens in its area of competence, which starts with the publication of the decision to make an offer. Before that, general corporate law remains applicable.

However, it can be stated that German general corporate law, as interpreted by a majority of the legal literature in the context of hostile takeovers, places more emphasis on ensuring the freedom of the shareholders to sell their shares than does the WpÜG, whose basic approach seems to be to enhance the management's room for manoeuvre in acting in the face of an attempted hostile takeover. Therefore, it contradicts the principles outlined in general corporate law in many respects. This is a result which should be avoided, and instead of imposing the regulations of the WpÜG even against the concepts of corporate law, the WpÜG should instead be aligned with corporate law as it stood in the first drafts of the WpÜG.

[598] §§76, 93 AktG, see Winter & Harbarth, *supra* note 561 at 4; "Aktionärskreis", *supra* note 564 at 558ff.
[599] „Managementpflichten", *supra* note 44 at 1826.
[600] See D.II.3.

f) Stakeholders' interests

In Germany, it is widely accepted that the management is bound to the interests of the company. This, according to the consensus of opinion, includes the shareholders and the stakeholders as well as the public[601]. The interests of the shareholders and of the company as a whole, however, have priority in the management decision making[602]. This is, among other reasons, due to the fact that the interests of the employees are already subject to other regulations, which are explicitly aimed at their protection.[603].

§3 II WpÜG states as a general principle that the management and the supervisory board have to act in the interests of the target company, which also means the interests of the shareholders, the employees and the interests of the company as a whole[604]. If the management follows the principle not to interfere with the shareholders' ability to accept an offer, this focus will be shifted to regarding the shareholders' interests, so that this constitutes an exception to the general rule. The actual provision, however, enables the management in many cases to act as if there was no offer, which means that the focus shifts to the general duty again. In its decisions which are approved by the shareholders or the supervisory board, the management has to take into account the interests of the company as a whole.

4. Conclusion and Outlook

One can see a clear shift in attitude concerning the use of defensive measures between the second and the third draft of the statute. Whereas one of the objectives of the first drafts was not to support, but also not to hinder hostile takeovers, later the emphasis on the negative effects of hostile takeovers seemed to prevail, which eventually lead to the rejection of the 13th Directive and to the adoption of provisions which extensively enable the management to use defensive measures[605]. This change in attitude was due in large

[601] „Managementpflichten", *supra* note 44 at 1822.
[602] Dimke & Heiser, *supra* note 66 at 245.
[603] „Managementpflichten", *supra* note 44 at 1822.
[604] Möller & Pötzsch, *supra* note 567 at 1265.
[605] Drygala, *supra* note 160 at 1861.

part to the interference of the chairmen of several large German companies[606], which illustrates that political considerations ultimately triumphed. This direction was also supported in German legal literature[607], although the principal body of opinion still favours the original approach to regulation.

The future development of German takeover law is dependent on the enactment of a new 13th Directive, since then the national law has to be adapted within a certain period of time. The creation of a new Directive which enables a harmonization within the EU, on the other hand, is dependent on the cooperation of Germany. Therefore, it has to meet the German concerns, while at the same time not deterring the other countries, among which many voted in favour of the concept of the neutrality of the management.

One of the arguments of the German Government in respect of why it finally drifted from a takeover-friendly regulation to one which is capable of substantially creating barriers to hostile takeovers was the need to establish a level playing field with other European countries, which still have in many cases, mechanisms such as maximum or multiple voting rights and golden shares. It was argued that they therefore had greater opportunities to close the door on hostile takeovers than did Germany, which has recently abolished the possibility of maximum voting rights[608], and does not permit multiple voting rights either[609]. The same reasoning was also used in relation to the US, where the directors have the permission to use a wide range of defensive measures[610].

One solution, which was already considered by the EU Commission, is to include the regulation of voting rights into the Directive, and to restrict multiple and maximum voting rights, so that in this way no country is at disadvantage[611]. The other proposal would be to allow maximum voting rights, which have just been abolished in 1998[612]. This, however, would not be a very satisfactory result since, even if it might favour a regulation

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606 *Ibid.*
607 *Ibid.*
608 Liebscher, *supra* note 571 at 854; see §134 I 2 AktG.
609 §12 II AktG.
610 Hommelhoff & Witt, *supra* note 523 at 566.
611 Drygala, *supra* note 160 at 1868.

determining the neutrality of the management, it would at the same time create new impediments to gain control, which are suitable to substantially hinder hostile takeovers. This solution would suggest that the best way to create a harmonized takeover regulation would be to adapt the defensive measures used in other countries, which is entirely at odds with the purpose of the European takeover law. Its aim is to harmonize the regulations of the countries and to support the competitiveness of the EU countries, while at the same time not hindering hostile takeovers.

The argument that not only does fairness among EU states have to be upheld, but also among Europe and the US, where in the latter companies are allowed to use a wide range of defensive measures, does not altogether convince one that it is necessary to abolish the concept of neutrality. As it was already outlined above[613], the lack of harmonization in that context, which, in opposition to within the EU, is almost impossible to achieve unless the European countries regulate hostile takeovers the way the US does, does not necessarily constitute a disadvantage, mainly because it improves the possibilities for European companies to raise capital.

Apart from the arguments cited above, the point of view has been expressed that the regulation of defensive measures which is applied in the US should work in a similar form in Germany as well[614]. There are two main points to be raised against this: First of all, this kind of regulation has been widely criticized in the US as well[615], and is mainly due to political, and not advantageous economic, reasons. Second, the markets in the US and Germany are not directly comparable, since, for example, the offer conditions in the US are much less strict than in Germany, and the US has greater judicial control than Germany[616].

Since the arguments in favour of the neutrality of the management are much more convincing than the arguments against, the German government should rethink the

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[612] *Ibid.*
[613] See D.III.
[614] „Managementpflichten", *supra* note 44 at 1830.
[615] Drygala, *supra* note 160 at 1869.

regulation of defensive measures, especially in the context of the new draft of a European Directive. It would be a mistake to follow the US and place more weight on political considerations than on economic and legal reasoning. Many countries in Europe have retained additional defensive measures in certain forms such as flexible voting rights or golden shares. On the other hand, many favour the concept of managerial neutrality, as was shown by the discussions about the last draft of the European Directive and especially by the fact that many adopted a regulation which is based on the City Code on Takeovers and Mergers[617]. Germany should take part in this development, in order to support economic harmonization, and to remain competitive in Europe.

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[616] *Ibid.* at 1869f.
[617] See E.II.3.

G. FINAL CONCLUSION

The first chapters of this thesis contain an extensive review of the different factors which are relevant in assessing which method of the regulation of defensive measures in hostile takeovers is the most suitable from a purely theoretical point of view. In legal and economic literature, these factors have been assigned varying degrees of importance, and have therefore sometimes not been considered at all or have been granted excessive emphasis, depending on the motivation for their examination and in respect of which country this was done. An analysis of the subject matter in conjunction with all of the factors previously addressed in this thesis enables one to come to a well-reflected and rigorous view as to how defensive measures should be regulated, irrespective of the country or region one is contemplating.

Firstly, the question of whether defensive measures should be used to defend a hostile takeover has been assessed in light of the interests that are pertinent once an attempt at a hostile takeover has taken shape. In this context, importance has been attached to the interest of the shareholders in retaining the opportunity of selling their shares to a hostile bidder. It has been shown that it is not the role of the directors to intrude upon that beyond the giving of information and impartial advice.

Defensive measures do not only have to be assessed in the realm of their narrow workings but should also be considered from the perspective of their prevalence having potentially significant effects on the macro economy, for whole industries and national economies. In the end, this boils down again to assessing the concerns of shareholders, but in another respect. These concerns are mainly the potential to have an additional means of appraising the management, an efficient resource allocation of a company, and ensuring that the board does not pursue an excessively short term strategy.

A regulation which leaves the decision of whether or not to reject another company's hostile advances to the shareholders can in this way address many of the concerns outlined above. In general, the merits of hostile takeovers largely outweigh their costs. Ultimately, shareholders should always be able to decide whether they want to protect the company from being taken over, or whether they want to use defensive measures to initiate an auction in order to increase any premium being paid. The risk that the measures taken might deter any bidder then lies with the shareholders.

To enable the shareholders to make a well informed decision, and to make clear the effects that the incidence of hostile takeover activity might have both on the economy as a whole, as well as on companies not targeted, the shareholders should be given clear information before making their decision. This information should be provided to them by the board, which, on their behalf, possesses better knowledge than they do. It should be ensured, however, that this information is accurate and objective, which can be done by using external independent advisors.

One ought not neglect to consider that other parties are affected by an actual or potential hostile takeover, especially the employees of companies and other stakeholders. Hostile takeovers can have both positive and negative effects on their interests, which, in the case of employees, is to secure their position and be able to rely on implicit contracts made with the company. In the short term, however, hostile takeovers can often do damage to these interests. Consequently, the implementation of mechanisms designed to protect the rights of employees and other shareholders should be considered. This is not best achieved by regulating the takeover, where the interests of the shareholders usually remain paramount, but rather by addressing particular concerns in other arenas, such as labour law.

Therefore, in respect of potential ways of regulating defensive measures in hostile takeovers, the following approach, previously outlined in chapter D appears the most advantageous: rules establishing the neutrality of the management, leaving the final decision about defensive measures to the shareholders, set up by a self-regulatory body, preferably by the securities administrators, who should also enable a dispute resolution process which is quick and tailored to practical needs, with the possibility of referral to judicial review of the decisions made.

The last two chapters have examined many of the possible ways to regulate hostile takeovers and the use of defensive measures, both in form and drafting, as applied by four of the leading western industrial nations. Only one country, however, basically uses the best model as set out earlier, namely, the United Kingdom.

In the Canadian and American approaches, there are similarities evident in the jurisdictional structure of regulation, but in the actual content, Canada seems to have paid greater heed to the British approach. Harmonization efforts within the EU, which would create nearly identical conditions in the UK and Germany, have failed, with the UK and Germany both taking opposing stances on the desirability of hostile takeovers, which can be seen in the slow progress of attempts to introduce the proposed Directive.

This demonstrates that more than just theoretical economic and legal considerations, which are often at odds with the actual regulations in many countries, are playing a role in what kind of regulation is finally enacted. Other factors such as political pressures, the prevailing legal environment, economic structures and ingrained attitudes towards hostile takeovers are also crucial in determining the possible moving of boundaries within this field. This explains the diversity of regulation in the field of hostile takeovers, especially of defensive measures, despite the universality of the considerations outlined above.

The growth of international capital markets and increasing numbers of cross-border transactions might lead to a convergence of these different systems. This is, in all likelihood, going to be a long term process. The question is whether a harmonization of the regulation of hostile takeovers might in itself accelerate the integration of international markets. Due to the wide reach of this subject which intrudes into many other areas of law and economic theory, this might be a problem, since the national differences, in many cases, might not be overcome so easily. This is demonstrated in the attempts to establish an EU Directive. There also remain many outstanding issues at a national level of the different countries.

When assessing existing regulations in light of the considerations elaborated in the first chapters, concerning factors to be taken into account in formulating a regulation, the following matters, particularly in respect of certain countries, seem to be especially problematic in practice: Firstly the degree of power afforded to the directors in opposing a hostile takeover, and the extent to which the shareholders should have the right to make decisions. The prevailing positions are on the one hand the ones favouring a judicial review of the directors' actions which are subject to a fiduciary standard set out in corporate law, and on the other hand the ones leaning towards a clear distribution of competences in the form of explicit rules, which give an indication as to what kind of directorial behaviour infringes the rights of the shareholders. In this context, especially on the subject of shareholder rights plans as the classic defence developed in the US, there is controversy, but also on the matter of other forms of defensive measures.

The second main concern is which authority should be charged with governing defensive measures in hostile takeovers, and whether it is advisable to deal with it under the banner of corporate law or securities regulation. The latter often implies a scheme of self-regulation which is merely supervised by the securities authorities. This question is in some ways linked to the first one, since the proponents of a regulation by way of assigning fiduciary duties to directors treat the topic of defensive measures as a matter of corporate law, to be regulated by the courts and typically reject any regulation through administrative bodies such as the securities administrators.

There is also the outstanding problem of the scope of any regulation. If only defensive measures as such are to be regulated, other comparably efficient means of hindering the success of hostile takeovers might be left out, thus hindering the development of international markets. These include special voting rights, which are an impediment to the efficient acquisition of control over a company. The restriction of these instruments should therefore be included in any regulation, at least in the context of a hostile takeover. Other structural obstacles, such as concentrated shareholdings and the influence of institutional investors, can also be influenced by legal regulation. Attempting to include this in the harmonization of hostile takeover regulation is going too far however, since these are areas which affect hostile takeovers, but are not purely targeted at them, and would consequently distort other areas of law and economic structure.

These conclusions show that even if, from a theoretical point of view, satisfactory schemes of taking into account the relevant interests can be formulated, in most countries there has not been such an adequate solution, largely because of external factors pitted against reform. This is especially the case in the context of the harmonization of hostile takeovers.

The EU currently has the opportunity to choose a model which will, if approved by a majority of the member states, substantially influence the prevalence and economic effects of hostile takeovers in both the national economies and on an EU wide basis. This has the potential to become a cornerstone in the development of hostile takeovers. Only time and the determination of the Commission in developing an integrated economic power will show whether the correct path is chosen .

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