

HOSTILE TAKEOVERS AND DIRECTORS' DUTIES: FROM  
DELAWARE TO BRUSSELS, WHAT'S BEST FOR  
SHAREHOLDERS?

by

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by

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2008

To my wonderful family and many friends

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# HOSTILE TAKEOVERS AND DIRECTORS' DUTIES: FROM DELAWARE TO BRUSSELS, WHAT'S BEST FOR SHAREHOLDERS?

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## Abstract

This thesis attempts to address the crucial issue of the appropriate role of corporate boards in response to hostile takeover bids. In such circumstances, directors face an obvious conflict of interests: since they might lose their jobs and benefits once the acquisition is completed, they may use their corporate powers to erect takeover defenses or to simply veto the offer. As a matter of doctrine, the debate falls into two schools of thoughts. The managerialist school supports that boards should be permitted to erect defenses and/or veto on the grounds that directors are better placed to protect the interests of shareholders whereas the shareholder choice school relies on the conflict of interest to support boards' passivity. As a matter of practice, the U.S. system adopts an approach that is more consistent with managerialism, while the recent European takeover directive advocates in essence that shareholders are the only ones that should take the ultimate decision.

At the end of the day, we must ask ourselves "What's best for shareholders?"

## Résumé

Pléthore d'hypothèses, de théories et d'arguments ont été développées au sujet du rôle des dirigeants de sociétés cotées lors d'offres publiques d'achat hostiles. Le conflit d'intérêts dont les intéressés font face est évident: le risque notable de se voir remercié à la suite de l'acquisition, et *de facto* de perdre les avantages pécuniaires directement associés à leurs positions, les conduit le plus souvent à rejeter une offre, fut-elle favorable aux actionnaires. De ce débat éminemment important pour le droit des sociétés, deux écoles se distinguent. L'école « managériale », que les Etats-Unis ont pris comme modèle, se fait l'avocate d'un système dans lequel les dirigeants garderaient les pouvoirs de négocier et éventuellement de refuser une offre, ceci dans l'intérêt de leurs actionnaires. L'école actionnariale, au contraire, argue de la nocivité du conflit d'intérêt ainsi que des droits fondamentaux des actionnaires de pouvoir se prononcer sur le destin de la société, afin de leur conférer l'autorité décisionnelle. Ainsi se positionne la toute récente directive européenne sur les offres publiques d'achat.

Reste la question cruciale dont la présente thèse s'attache à répondre: lequel de ces deux systèmes bénéficie au mieux les actionnaires ?

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“More rubbish than wisdom has been talked about takeover bids”.<sup>1</sup>

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<sup>1</sup> *The Economist* (31 October 1959), cited in John Armour & David Skeel, “Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation”, online: (2007) SSRN: <<http://ssrn.com/abstract=928928>> [Armour, “Rules for Hostile Takeovers”].



## Introduction

The well-known Indian parable of the *Six Blind Men and the Elephant*<sup>2</sup> is not inept to the discrepancies between the U.S. and European takeover regulations, and its moral may utterly apply to the debate over the role of target directors when a hostile bid occurs. The poem puts on to six blind men attempting to picture an elephant by touching one of its members only. The first one, who fell against its broad and sturdy side, came to the conclusion that the animal was like a wall. The second one believed it was like a spear after having felt the tusk in his hand. The third blind man touched the squirming trunk and thought the elephant to be very like a snake. The fourth one, while handling its knee, considered it as a tree. The fifth one believed it was like a fan after having touched its ear whereas the last one took for granted that the elephant was like a rope as he touched its swinging tail. Over all, each of them was convinced that his opinion was truthful.

So what does this fable tell us? Basically, it holds that reality may be viewed differently depending upon one's perspective. It also warns us against the extrapolation from only portion of reality in all manner of dogmas – parallels with religion may be drawn – where every single person claims his/her version to be the correct and only version.<sup>3</sup> Like the elephant, specific features of hostile takeovers have been differently contemplated by the U.S. and European authorities, thus leading to different regulations of the role of corporate boards. Indeed, from Brussels to

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<sup>2</sup> For a complete study of the fable, see Edith Feistner & Alfred Holl, *Mono-Perspective Views of Multi-Perspectivity: Information Systems Modeling and the Blind Men and the Elephant* (Växjö: Växjö University Press, 2006), available online: <[http://www.informatik.fh-nuernberg.de/professors/Holl/Personal/Elfant\\_Acta.pdf](http://www.informatik.fh-nuernberg.de/professors/Holl/Personal/Elfant_Acta.pdf)>.

<sup>3</sup> Alan Kazlev, "The Blind Men and the Elephant", online: (2007) Kheper Website <[http://www.kheper.net/topics/blind\\_men\\_and\\_elephant/](http://www.kheper.net/topics/blind_men_and_elephant/)>.

Delaware,<sup>4</sup> almost diametrically opposed choices have been made by respective judges and lawmakers regarding the question that represent the “nuclear threat of corporate law, the most dramatic of all corporate governance devices”,<sup>5</sup> that is to say who shall – directors<sup>6</sup> or shareholders – have the ultimate power to decide whether the corporation should be sold. The choice of subject jurisdictions – Delaware and the European Union – is personal and pragmatic: as an American lawyer from French origins specialized in trans-Atlantic acquisitions, the author wanted to cover what he feels closer to and what he will be the more exposed to in practice.

As a matter of fact, companies’ external growth may be sought through the common practice of hostile takeover,<sup>7</sup> which can be defined in simple words as general and public offer made to all the shareholders of the target company over the heads of target management.<sup>8</sup> Surprisingly enough, this specific method of acquiring

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<sup>4</sup> Today, more than half of all U.S. public companies are incorporated in Delaware, and the influence of Delaware courts on U.S. corporate law is considerable. For nearly a century Delaware’s corporation law has dominated its market. It is the only state with a specialized Chancery Court for resolving corporate law disputes and its laws are relatively certain and well-known. Therefore, Delaware corporate law is a good reference for comparative studies. See e.g. Guhan Subramanian, “The Influence of Anti-Takeover Statutes on Incorporation Choice: Evidence on the ‘Race’ Debate and Anti-Takeover Over-Reaching” (2002) 150 U. Pa. L. Rev. 1795; Lucian A. Bebchuk & Alma Cohen, “Firms’ Decisions Where to Incorporate” (2003) 46 J. L. & Econ. 383 (“During the period 1996-2000, 58% of all publicly held firms, and 59% of the Fortune 500 Industrial firms were incorporated in Delaware” at 389); See also Robert Daines, “The Incorporation Choices of IPO Firms” (2002) 77 N.Y.U. L. Rev. 1559 (“During the period 1978-2000, 56% of all initial public offerings involved Delaware corporations” at 1571).

<sup>5</sup> Armour, “Rules for Hostile Takeovers”, *supra* note 1 at 7.

<sup>6</sup> As a matter of linguistic economy and practical simplicity, I will refer in this thesis to those who manage the corporation collectively, even though I agree with Professor Stephen Bainbridge on the dangers of failing to recognize the distinction between the roles of corporate officers/managers and corporate directors. See Stephen M. Bainbridge, “Director Primacy and Shareholder Disempowerment” (2006) 119 Harv. L. Rev. 1735.

<sup>7</sup> See e.g. David B. Jemison & Sim B. Sitkin, “Acquisition: The Process Can Be a Problem” (1986) 86 Harv. Bus. Rev. 107 (“The use of acquisitions to redirect and reshape corporate strategy has never been greater. Many managers today regard buying a company for access to markets, products, technology, resources, or management talent as less risky and speedier than gaining the same objectives through internal efforts” at 108). Also, for an exhaustive description of the different acquisition techniques, see Marco Ventrone, “The Thirteenth Directive and the Contrasts Between European and U.S. Takeover Regulation: Different (Regulatory) Means, Not so Different (Political and Economic) Ends?”, online: (2005) SSRN: <<http://ssrn.com/abstract=819764>> [Ventrone, “Contrasts”].

<sup>8</sup> Stephen Kenyon-Slades, *Mergers and Takeovers in the US and UK: Law and Practice Mergers and Takeovers in the US and UK* (Oxford: Oxford University Press, 2004) at 50.

companies was first employed in Europe – in the United Kingdom – in the early 1950s and only appeared in the U.S. a decade later.<sup>9</sup> The fascinating feature about these unsolicited bids is without a doubt the “obvious and inherent conflict of interest”<sup>10</sup> that might occur between the board of directors and its shareholders once the offer is made. To be clear, in everyday’s business life, the management of corporations is generally reserved to the former whereas the latter is usually conferred a relatively minor role in the governance. This model is however brought into question once a bidder comes into the equation, since directors might use their veto power or simply erect takeover defenses – poison pills for example<sup>11</sup> – to obstruct offers that could be beneficial to shareholders. To make things clear, corporate law does not literally allow a board to prevent a takeover bid from proceeding. In practice however, a board may have powers to implement a poison pill that grant it a *de facto* veto. The apprehension to lose their jobs and benefits sometimes leads them to do anything in order to remain in power.<sup>12</sup> On the contrary, it is also argued that had shareholders the decision-making power, they might be less informed to make the right choices at the right time, and would not be able to properly and effectively conduct auctions. Accordingly, powers over the takeover decision should remain in corporate boards’ hands.

Wrestling with this dilemma is contributing to what has been referred to as the takeover debate and which generally involves two school of thoughts, both finding application – though not fully – in the real world. The U.S. model, through the

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<sup>9</sup> *Ibid.* at 51-52.

<sup>10</sup> Ronald Gilson, “A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers” (1981) 33 Stan. L. Rev. 819 at 820 [Gilson, “Structural Approach”].

<sup>11</sup> For a clear definition of the poison pill, see Christian Kirchner & Richard W. Painter, “Towards a European Modified Business Judgement Rule for Takeover Law”, online: (2000) SSRN: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=247214](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=247214)> (“A poison pill is a ‘shareholder rights’ contract between a company and its shareholders [...] that is triggered by an event such as a tender offer or another person gaining a control block of the company’s stock. The contract allows shareholders to purchase new shares or debt securities of the corporation at a discount, thereby raising the corporation’s debt or diluting the value of its stock and making an unfriendly takeover difficult” at 21) [Kirchner, “European Modified Business Judgement Rule”].

<sup>12</sup> Gilson, “Structural Approach”, *supra* note 10 at 820.

Delaware jurisprudence, has fallowed, not without some ambiguity, the managerialist school sustaining that directors *must* retain a large freedom to adopt defensive measures in response to hostile takeovers, including, when justified, the right to “just say no”.<sup>13</sup> The European Union regulation, on the other hand, precludes directors from adopting any defense by enforcing a strict neutrality rule, thereby praising shareholder choice theories. This very consideration has been legally enforced in almost every member states for years, and has found recognition in the recent European Takeover Directive.<sup>14</sup> However, some countries, of which Germany comes first, decided to remain more inclined with U.S. board defenses style.

A deep study on the role of corporate directors vis-à-vis target shareholders is stressed not only because of the possible outgrowths it may have on essential and basic notions of corporate law, but also because we have a duty to highlight the global and practical challenges lawyers may have to face in cross-Atlantic acquisitions.

It is generally agreed that the takeover debate reflects a fundamental struggle between competing models of the corporation and the allocation of corporate assets.<sup>15</sup> If the ultimate goal of corporate law is the maximization of shareholders’ wealth as it is usually argued,<sup>16</sup> there is therefore legitimate relevance in examining which of the two systems ensure the highest return for target shareholder in the event of a hostile

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<sup>13</sup> For an exhaustive study on takeover defenses, see Ventoruzzo, “Contrasts”, *supra* note 7 at 18. See also Goeffrey P. Miller, “Takeover: English and American” (2000) 6 European Financial Management 533 at 535.

<sup>14</sup> EC, European Parliament and Council Directive 2004/25/EC of 21 April 2004 on takeover bids [2004] O.J. L 142/12 [*Directive*].

<sup>15</sup> See William T. Allen, Jack B. Jacobs & Leo E. Strine, “The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide” (2002) 69 U. Chicago L. Rev. 1067 [Allen, “Great Takeover Debate”]. See *contra* Marcel Kahan & Edward B. Rock, “How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law” (2002) 69 U. Chicago L. Rev. 1067 (arguing that the takeover debate has lost much of its practical significance in part because of the developments of executive compensation) [Kahan, “Love the Pill”].

<sup>16</sup> See Adolph A. Berle, “Corporate Powers as Powers in Trust” (1931) 44 Harv. L. Rev. 1049.

takeover.<sup>17</sup> Also, the recent large-scale financial scandals – the collapse of Enron, Arthur Andersen, WorldCom etc. – having virtually destroyed public’s trust in our corporate leaders and financial markets,<sup>18</sup> remind us that corporate governance matters and that shareholders’ protection has become a pillar of modern corporate law. Special attention, if not exclusive, is now given to shareholders’ protection,<sup>19</sup> although hostile takeovers affect every corporate constituency of the target company and the acquirer’s shareholders, directors, officers, employees, customers, creditors, and local communities. For these reasons, when asking the question as to whether target shareholders should freely sell their shares to a hostile bidder, or should the target board have to right to oppose and/or defeat the offer, we *must* know which system – the U.S. or the European one – benefit shareholders’ investments the most.

Also, the discrepancies between the U.S. and European takeover regulations system are undoubtedly going to play, in the next few years, an important role in shaping the international takeover scenario, and *a fortiori* the cross-Atlantic economic landscape: cross-border acquisitions, and especially hostile takeovers, represent “one of the most dramatic consequences of the growing integration, both within Europe, and when considering the economic balance of power between the U.S. and the

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<sup>17</sup> Indeed, there are recent studies in the United States and Europe that provide evidence of a correlation between corporate governance and a company’s share price. See e.g. Wolfgang Drobetz, Andreas Schillhofer & Heinz Zimmermann, “Corporate Governance and Expected Stock Returns: Evidence from Germany”, online: (2003) SSRN: <<http://ssrn.com/abstract=379102>>.

<sup>18</sup> See e.g. Jeffrey D. Hern, “Comment: Delaware Courts’ Delicate Response to the Corporate Governance Scandals of 2001 and 2002: Heightening Judicial Scrutiny on Directors of Corporations” (2005) 41 Willamette L. Rev. 208 (“The political and economic climate changed drastically in 2001 and 2002. The storied collapses of Enron, WorldCom, and other major public corporations exposed the pervasiveness of corruption in corporate America. The need for new corporate governance rules became glaringly apparent” at 209).

<sup>19</sup> For e.g., see the recent developments for corporate governance in France, see Perry E. Wallace, “The Globalization of Corporate Governance: Shareholder Protection, Hostile Takeovers and the Evolving Corporate Environment in France” (2002) 18 Conn. J. Int’l L. 1.

European industries”.<sup>20</sup> It is however surprising that the new European directive regulating takeovers received only “scant comment” in American legal scholarship.<sup>21</sup>

Finally, the importance of the takeover debate is amplified by the vitality of the takeover market which has steadily increased on both sides of the Atlantic Ocean in the last few years. The U.S. activity in the second quarter of 2006 rose to \$368.3 billion,<sup>22</sup> up from the first quarter’s \$333.7 billion<sup>23</sup> and 2005’s second quarter of \$167.8 billion.<sup>24</sup> Total U.S. aggregate transaction dollar value for the first six months of 2006 was \$702 billion.<sup>25</sup> Although hostile takeovers have historically been so infrequent as to be a non-issue in the E.U.,<sup>26</sup> European transaction value increased from \$355.4 billion in the first quarter<sup>27</sup> to \$362.9 billion in the second quarter to reach a global value \$718.3 billion in the second quarter.<sup>28</sup> Accordingly, the European economy seems to surpass the U.S. and to some eminent scholars, European multinationals dominate American corporations in numerous strategic industries,<sup>29</sup> and European corporations are “taking over American corporations at a higher rate than American corporations are reciprocating”.<sup>30</sup>

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<sup>20</sup> Ventrone, “Contrasts”, *supra* note 7 at 4.

<sup>21</sup> *Ibid.*

<sup>22</sup> *Second Quarter 2006 Mergers and Acquisitions Review* (June 2006), online: Thomson Financial: <<http://banker.thomsonib.com>>.

<sup>23</sup> *First Quarter 2006 Mergers and Acquisitions Review* (March 2006), online: Thomson Financial: <<http://banker.thomsonib.com>>.

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

<sup>25</sup> See *supra* note 22.

<sup>26</sup> Erik Berglöf & Mike Burkart, “European Takeover Regulation”, online: (2003) SSRN <<http://ssrn.com/abstract=405660>> at 189-191; See also Kirchner, “European Modified Business Judgement Rule”, *supra* note 11 (“Although mergers and acquisitions activity in Europe has reached unprecedented levels, almost doubling in the past year alone, hostile takeovers are still the exception, not the rule, especially in Germany” at 1).

<sup>27</sup> See *supra* note 23.

<sup>28</sup> See *supra* note 22.

<sup>29</sup> Jeremy Rifkin, *The European Dream* (New York: Tarcher/Penguin, 2004) at 58, 66.

<sup>30</sup> Ventrone, “Contrasts”, *supra* note 7 at 4; see also Guhan Subramanian, “The Influence of Anti-Takeover Statutes on Incorporation Choice: Evidence on the ‘Race’ Debate and Anti-Takeover Over-Reaching” (2002) 150 U. Pa. L. Rev. 1795 (“During the 1990s takeover wave, European companies bought American companies at a far greater rate than American companies bought European companies. European acquisitions of American companies amounted to almost \$700 billion in the 1990s [...] compared to approximately \$250 billion in American acquisitions of European companies [...] at 1868).

To answer the question “Who *should* decide?”<sup>31</sup> is generally thorny. It is not impossible however when light is exclusively shed on a particular corporate constituency. In this modest thesis, we argue that the board’s ability to defend the “corporate citadel”<sup>32</sup> against a bid is indispensable to corporate shareholders’ investments. To defend this hypothesis, Chapter 1 attempts to accustom the reader with the takeover debate that has been happening in the U.S. for almost thirty years. The quality of the information regarding the offer, the motives of the bidder, the target directors’ personal benefits, and the market efficiency are among the numerous arguments that were intensely exchanged between academics from the two schools of thoughts. Chapter 2 offers a comprehensible, practical and comparative outlook of the application of the takeover debate arguments in the real world. In the U.S., takeover regulation has adopted an approach that is more consistent with managerialism than shareholder choice, generally allowing corporate boards extensive powers, although without saying whether this is to serve the interest of the shareholders or the interests of the corporation. This last point may explain, in part we believe, the lack of U.S. jurisprudence purity. On the contrary, the European system approves and follows the shareholder choice ideals by explicitly rejecting managerial discretion in favor of a shareholder-oriented strategy – the neutrality rule – for regulating takeovers. Finally, Chapter 3 provides empirical, economic and financial opinions to emphasize that shareholders are better off leaving the power to decide over a hostile takeover bid. We will also show that giving shareholders control over defensive tactics would paradoxically work against their own interests, to ultimately reach the conclusion that

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<sup>31</sup> Stephen M. Bainbridge, “Director Primacy in Corporate Takeovers: Preliminary Reflections” (2002) 55 Stan. L. Rev. 791.

<sup>32</sup> Lucian A. Bebchuk, “The Case Against Board Veto in Corporate Takeovers” (2002) 69 U. Chicago L. Rev. 973 at 988 [Bebchuk, “The Case Against Board Veto in Corporate Takeovers”].

by far the best way for shareholders to protect the money they invest is to do it in U.S. companies.<sup>33</sup>

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<sup>33</sup> I concede that there are several disadvantages in the U.S. model, but, in a shareholders' protection perspective, they do not outweigh the European ones.



## **Chapter 1**

### **1. The Theoretical Approaches to the Takeover Debate**

For the reader's best understanding of the issues and the outgrowths that are at stake, as well as for a consistent and comprehensible analogy, Chapter 1 will approach the takeover debate on a "general to specific" basis. At the outset, we show that the takeover debate is in keeping with the more widely question of the purpose of the corporation currently opposing shareholders and stakeholders model proponents (1.1). Then, by "zooming" on the hostile takeover event, we see that the takeover debate lies beneath the aftermaths of the conflict of interest that might arise. There is indeed an existing concern that directors and shareholders' interests diverge in the hostile takeover context, generating what is usually referred to as agency costs (1.2).<sup>34</sup> To solve this inherent conflict and reduce the associated agency costs, early arguments were defended in the 1980s for and against boards' veto (1.3). Richer arguments were developed later, and are still exchanged today, in a feud that is opposing the so-called Hamiltonians and Jacksonians (1.4, 1.5).

#### **1.1. The Takeover Debate, A Natural Progression From the Shareholder/Stakeholder Debate**

For years, corporate law scholars have strongly opposed their views on the function of the corporate entity.<sup>35</sup> Some argue that the core purpose of the

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<sup>34</sup> We assume in this thesis that the relevant agency problems are those which arise between the shareholders of the target company and their board of directors in relation to the takeover decision.

<sup>35</sup> For recent and useful studies on the shareholder/stakeholder debate, see Henry Hansmann & Reinier H. Kraakman, "The End of History for Corporate Law" (2001) 89 Georgetown Law Journal 439;

corporation is to achieve the best result for the current shareholders (so called “shareholder model”) whereas others sustain that it is to maximize the value that the corporation generates as an entity, regardless of whether that is in the best interests of the shareholders (so called “stakeholder model”). The important point for the thesis is that the takeover debate is no more than a natural progression from the “old but persistent”<sup>36</sup> stakeholder/shareholder debate which starts off simply as a question of to whom does a director owe the duty of loyalty.

Stakeholder model proponents sustain that the proper purpose of the corporation is not simply to make money for shareholders. Professor Merrick Dodd argued for “A view of the business corporation as an economic institution which has a social service as well as a profit-making function”.<sup>37</sup> To achieve such an objective, supporters view directors’ decision-making as primary; the corporation’s *raison d’être* being broader than simply shareholders’ wealth, all the constituencies should have their interests considered by boards of directors, from more secure jobs for employees, better quality products for consumers, to greater contributions to the welfare of the community as a whole.<sup>38</sup>

“Is not generated solely by stockholders but also by the corporation’s other constituencies, whose incentives to make firm-specific investments will be greatly reduced if those other constituencies believe their contributions can be expropriated

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Margaret M. Blair & Lynn A. Stout, “A Team Production Theory of Corporate Law” (1999) 85 Va. L. REV. 247 [Blair, “Team Production”]; Lynn A. Stout, “Bad and Not-So-Bad Arguments For Shareholder Primacy” (2002) 75 S. Cal. L. Rev. 1189 [Stout, “Shareholder Primacy”]; Allen, “Great Takeover Debate”, *supra* note 15. For the classic 1930s Dodd/Berle debate, see Adolph A. Berle, “Corporate Powers as Powers in Trust” (1931) 44 Harv. L. Rev. 1049 [Berle, “Trust”]; E. Merrick Dodd, “For Whom are Corporate Managers Trustees?” (1932) 45 Harv. L. Rev. 1145 [Dodd, “Trustees”]; Adolph Berle “For Whom Corporate Managers Are Trustees: A Note” (1932) 45 Harv. L. Rev. 1365.

<sup>36</sup> Allen, “Great Takeover Debate”, *supra* note 15 at 1067.

<sup>37</sup> Dodd, “Trustees”, *supra* note 35 at 1148.

<sup>38</sup> Stout, “Shareholder Primacy”, *supra* note 35 at 1189.

unfairly any time the stockholders wish to sell the company at a premium”.<sup>39</sup>

Accordingly, directors are considered as an intermediating body charged with responsibility for acting as faithful trustees “Who balance the interests of the constituencies and forge a long-term path that generates the most benefit for all concerned”.<sup>40</sup> Thus, in the context of a tender offer, this school advocates that directors must be permitted to “just say no” on the shareholders’ behalf, if they believe that the offer is not in the long-run best interests of the corporation.<sup>41</sup>

At the other end of the spectrum, Adolph Berle and his supporters uphold that “All powers granted to a corporation or to the management of a corporation, or to any group within the corporation [are] at all times exercisable only for the ratable benefit of all the shareholders as their interest appears”.<sup>42</sup> The objective of the corporation is to maximize shareholders’ wealth by giving directors an implicit obligation to ensure that firms are run in the best interests of shareholders. Milton Friedman explains such a hypothesis by suggesting that, because the shareholders of the corporation are the owners of the business, the only “Social responsibility of business is to increase its profits”.<sup>43</sup> Therefore, shareholder model proponents generally oppose boards’ powers that interfere with the procession of a tender offer; as the owners of the business, shareholders must ultimately be allowed to decide for themselves whether to accept or to reject a tender offer.<sup>44</sup> Also, they argue that capital markets are generally efficient,

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<sup>39</sup> Raghuram G. Rajan & Luigi Zingales, “Power in the Theory of a Firm” (1998) 113 Q. J. Econ. 387 at 392, cited in Blair, “Team Production”, *supra* note 35 at 272.

<sup>40</sup> Blair, “Team Production”, *supra* note 35 at 291.

<sup>41</sup> Also mentioned is the reason that most investors hold a diversified portfolio: they may own stock of potential acquirers as well as stock of potential targets. Therefore, the profits they make as target shareholders are likely to be offset by losses in other parts of their portfolio and also by the overall loss in wealth creation caused by ill-conceived hostile deals. See Ronald J. Gilson, “Lipton and Rowe’s Apologia for Delaware: A Short Reply” (2002) 27 Del. J. of Corp. L. 37.

<sup>42</sup> Berle, “Trust”, *supra* note 35 at 1049.

<sup>43</sup> Milton Friedman, “The Social Responsibility of Business Is to Increase Its Profits” *New York Times Magazine* (13 September 1970) 32 at 122-26.

<sup>44</sup> See e.g. Ronald J. Gilson & Reinier Kraakman, “Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?” (1989) 44 Bus Law 247 (discussing the threat

and that the overall wealth of “Society will be enhanced in the long term if corporate control can be transferred relatively freely between buyers and sellers”.<sup>45</sup> Finally, it is argued that the shareholder model proponents leave room for shareholder choice because such a model would outweigh any social harm flowing from transfers that turn out badly.<sup>46</sup>

We need to anticipate a little bit, and mention here that eventually both managerialist and shareholder choice approaches have adopted the shareholder side of the shareholder/stakeholder debate. It is now the cornerstone of corporate law to serve the interests of shareholders, but the disagreement remains on how to do so, either by letting the managers decide in the shareholders’ interests or letting the shareholders themselves decide. Indeed, those in the shareholder camp who first argued against boards being able to resist takeovers came to realize that things were not as simple as they first seemed. Meeting the interests of shareholders is not necessarily the same thing as letting shareholders decide the fate of the corporation in the event of a takeover bid. Therefore, the shareholder side of the shareholder/stakeholder debate now includes both managerialists and shareholder choice proponents; even though a system may adopt a shareholder model of the corporation, it may – paradoxically in the face of it – empower directors with substantive powers to obstruct a takeover bid.

## **1.2. The Takeover Decision, the Conflict of Interest and the Agency Costs**

We acknowledge here that the agency theory is not the sacrosanct theory of the firm and that it has been challenged by economic models of the firm focusing rather

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of substantively coercive offers and arguing that only time-limited measures are proportionate responses) [Gilson, “Proportionality”].

<sup>45</sup> William Allen, “Our Schizophrenic Conception of the Business Corporation” (1992) 14 Cardozo L. Rev. 621 at 669.

<sup>46</sup> Allen, “Great Takeover Debate”, *supra* note 15 at 1071.

on transaction costs and hypothetical bargains among the various corporate constituencies.<sup>47</sup> We believe however that the principal-agent model still has currency, and is still relevant particularly in courts and among policymakers, businesspeople, and practicing attorney.<sup>48</sup> Also, we assume that the pioneers of the takeover debate took for granted, at the very beginning of the 1980s, that the agency theory was primary.

### 1.2.1. The Agency Theory: A General Introduction

The agency theory takes its roots in Berle and Means' classic study of the corporation which highlights a separation of ownership and control in U.S. public companies.<sup>49</sup> Volumes have been written about this theory in the economic, legal, or financial literature. In essence, it argues that shareholders' ownership has been historically too diffused and fragmented to effectively manage the corporation, in most part because of collective action problems and rational apathy making them unable to coordinate their activities. Effective control of the corporation thus ends up in the corporate board's hands.<sup>50</sup> The direct outgrowth of this separation is the specialization of the tasks whereby shareholders supply capital and bear the risk that

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<sup>47</sup> According to these theories, shareholders have control because they are residual economic claimants. For the property right theory, see Luigi Zingales, "In Search of New Foundations" (2000) 55 J. Fin. 1623. For the transaction cost theory, see Oliver E. Williamson, "Public and Private Bureaucracies: A Transaction Cost Economics Perspective" (1999) 15 J.L. Econ. & Org. 306.

<sup>48</sup> See e.g. Troy A. Paredes, "The Firm and the Nature of Control: Toward a Theory of Takeover Law" (2003) 29 J. Corp. L. 103 (explaining how the agency theory has dominated corporate law scholarship) [Troy, "Control"]; see also Frank H Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991) [Easterbrook, "Economic Structure"].

<sup>49</sup> Adolf Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932) [Berle, "Separation"].

<sup>50</sup> See *Ibid.* It seems important to mention in this footnote that the authors consider the notion of control as both the right to manage the corporation's business and affairs and the ability to determine who sits on the board of directors. ("Since direction over the activities of a corporation is exercised through the board of directors, we may say for practical purposes that control lies in the hands of the individual or group who may have the actual power to select the board of directors [...], either by mobilizing the legal right to choose them – 'controlling' a majority of the votes directly or through some legal device - or by exerting pressure which influences their choice [...] In most cases, however, if one can determine who does actually have the power to select the directors, one has located the group of individuals who for practical purposes may be regarded as 'the control'" at 69-70).

comes with their claim to the corporation's residual assets while the board uses its skills and expertise to develop and increase the shareholders' capital.

The relationship that exists between these two actors was conceptually defined by Michael Jensen and William Meckling in 1976 as an agency relationship, i.e. "A contract under which one or more persons engage another person to perform some service on their behalf which involves delegating some decision making authority to the agent".<sup>51</sup> In the corporate context, directors would therefore be the agents of the shareholders while shareholders, as principals, would have incentives to use resources to efficiently monitor the board with adequate powers such as the right to elect and remove directors.<sup>52</sup> A majority of the doctrine concludes that this principal-agent theory implies a shareholder primacy norm whereby directors and managers should run the corporation so as to maximize the wealth of shareholders.<sup>53</sup> Therefore, an implicit connection between the agency theory and the shareholder/stakeholder debate exists.<sup>54</sup>

With regards to the good governance of the corporation, the agency relationship described above is often a pipe-dream. As Adolf Berle and Gardiner Means observed, the separation of ownership and control creates a condition where the interests of shareholders and those of managers often diverge.<sup>55</sup> Separating ownership and control is not without potential agency costs: "Because managers cannot capture all

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<sup>51</sup> Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305 at 308 [Jensen, "Agency"]. The classical articles on the agency theory include but are not limited to Eugene F. Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J. Pol. Econ. 288; Eugene F. Fama & Michael C. Jensen, "Separation of Ownership and Control" (1983) 26 J.L. & Econ. 301.

<sup>52</sup> For a good study of the shareholder oversight, see Bernard S. Black, "The Value of Institutional Investor Monitoring: The Empirical Evidence" (1992) 39 UCLA L. Rev. 895.

<sup>53</sup> See generally Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 J. Corp. L. 277; see also Blair, "Team Production", *supra* note 35 at 280 (affirming that the principal-agent account implies such a duty by directors and managers).

<sup>54</sup> Obviously, this bilateral model of corporate governance leaves out an essential third player, i.e. the stakeholders. See e.g. John C. Coffee, Jr., "Unstable Coalitions: Corporate Governance as A Multi-Player Game" (1990) 78 Geo. L.J. 1495.

<sup>55</sup> Berle, "Separation" *supra* note 49 at 112-119.

of the gains if they are successful, and will not suffer all of the losses should the venture flop, they have less incentive to maximize wealth than if they themselves were the principals”.<sup>56</sup> As it was once said, “In Las Vegas lingo, directors are playing with other people's money”.<sup>57</sup> As a result, directors might deceive on their deal by opportunism, “shirking” or “stealing”, thereby reducing the corporation’s value to the detriment of shareholders. On this last point, Michael Jensen demonstrated that there are three different agency costs of the relationship: monitoring costs, bonding costs, and residual losses.<sup>58</sup> To be clear, in their effort to monitor agents, principals incur either “monitor costs” or “bonding costs” if agents bond their own performance. Divergences are inevitable – it is usually unfeasible or impossible for principals to perfectly monitor agent performance given the costs of shareholder monitoring of the board – leading to “residual loss”.

### 1.2.2. The Agency Theory: Specific Application to the Hostile Takeover Context

In our opinion, the hostile takeover environment remains *the* best example demonstrating the conflicts of interest between target directors and shareholders.<sup>59</sup> It

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<sup>56</sup> Daniel Fischel, “The Corporate Governance Movement” (1982) 35 *Banderbilt Law Review* 1259 at 1262.

<sup>57</sup> Cynthia A. Glassman, “Remarks on Governance Reforms and the Role of Directors before the National Association of Corporate Directors” (Speech given by SEC Commissioner, delivered in Washington D.C., 20 October 2003) [unpublished].

<sup>58</sup> Jensen, “Agency”, *supra* note 51 at 308.

<sup>59</sup> On the importance of the agency problem in the context of takeovers, see Bebchuk, “The Case against Board Veto in Corporate Takeovers”, *supra* note 32 (“The agency problem is more severe in the takeover context. Furthermore, in the takeover context we have the option, which is not viable or practical in most other corporate contexts, of letting shareholders decide. Indeed, the case against board veto in takeovers is not only consistent with, but in fact reinforces, the case for board power over other corporate decisions: the absence of board veto in takeovers provides a safety valve against management’s straying from shareholders’ interests in other corporate contexts” at 978).

On the comparison between the takeover decision and everyday business decisions, see *Ibid.* (“In fact, there are important differences, which call for a different treatment, between the takeover context and that of corporate decisions [...]. To begin, the concern that managers’ and shareholders’ interests might diverge is greater in the takeover context. Because managers’ control is at stake in the takeover context, managers’ preferences in this context are likely influenced by their private interests. In contrast, a divergence of interest is less likely to arise, and if it arises to be of great magnitude, in corporate contexts such as the considered investment decision. Therefore, given managers’ common ownership of shares and options, as well as their general interest in making the shareholders content, managers will

confronts us with “the omnipresent specter that a board may be acting primarily in its own interests”.<sup>60</sup> These divergences are relatively easy to draw and to understand. Let’s assume that the board is charged with receiving and negotiating a takeover bid. Given that the control transaction may be wealth-enhancing from a target shareholder’s perspective but might threaten directors’ jobs, privileges and/or benefits, the board may have personal incentives that conflict with its role of shareholders’ representative. Directors might lose their control and the private benefits associated with it if their company is taken over; this is supported by evidence showing that directors are unlikely to be retained on the new board following a successful takeover.<sup>61</sup> Corporate directors may therefore seek to use their corporate power to make the target less attractive to a potential bidder – by the use of a poison pill for example – or to prevent the offer being put to the shareholders, by simply refusing the offer.<sup>62</sup>

The agency costs incurred by shareholders subsequent to this conflict of interest are illustrated and emphasized by the economic doctrine in several studies. Surveys highlight that, if incumbent boards use their veto power to defeat bids, shareholders end up worse off compared with the scenario in which the bid would have been

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likely focus on enhancing shareholder value in such other corporate contexts. They might err and therefore make incorrect decisions. But their decisions are unlikely to be distorted substantially by their private interests” at 995).

<sup>60</sup> *Unocal Corp. v. Mesa Petroleum*, 493 A 2d 946 (Del. 1985) at 954.

<sup>61</sup> Jarrad Harford, “Takeover Bids and Target Directors’ Incentives: The Impact of A Bid on Directors’ Wealth and Board Seats” (2003) 69 *Journal of Financial Economics* 51 (the author starts with a sample of 1,091 directors from boards of Fortune 1000 firms receiving takeover bids between 1988 and 1991. The study tracks these directors’ abnormal change in directorships and relates them to director characteristics, target firm performance, and measures of how the offer was handled by the directors); see also Kenneth Martin & John McConnell, “Corporate Performance, Corporate Takeovers, and Management Turnover” (1991) 46 *Journal of Finance* 671; Erik Berglöf & Mike Burkat, “European Takeover Regulation” (2003) 18 *Economic Policy* 171 [Berglöf, “Takeover”].

<sup>62</sup> Tyler A. Theobald, “Hostile Takeovers and Hostile Defenses: A Comparative Look at U.S. Board Defence and the European Effort at Harmonization”, online: (2006) *Bepress Legal Series*: <<http://law.bepress.com/expresso/eps/1838>> (“Essentially, the threat of a takeover propels the board to act efficiently and in the best interests of the company and shareholders. Defensive tactics negate this market check by allowing even the inefficient board the power to entrench itself, thus negating any incentive to act more efficiently” at 24) [Theobald, “Hostile Takeovers”].



accepted. James Cotter and Marc Zenner found that when offers are defeated target shareholders suffer a 21 percent decline in their stock price.<sup>63</sup> That would be the case if, for instance, directors use a poison pill or their right to “just say no” in order to fend off and discourage the bidder just to keep their jobs. Another study showed that directors’ veto is often related to the negative effect of the bid on their financial interests.<sup>64</sup> Consistent with this, directors might be willing to trade off premiums to shareholders for personal benefits; it is showed that target directors are willing to accept lower acquisition premiums in transactions that involve an extraordinary personal treatment.<sup>65</sup> Finally, Julie Wulf evidenced that, even in friendly deals, CEOs are willing to trade off higher acquisition premiums in exchange for better managerial positions in the merged firm.<sup>66</sup> As a result, it seems that directors’ interests would paramount shareholders’ ones in the context of a takeover. The investors would thus suffer from the boards’ self preservation, and the costs incurred would be substantial.<sup>67</sup>

We will see in Chapter 3 that these costs however do not exceed the several benefits that a managerial model provides. To make it clear, we do not disagree that the directors are obligated to run the corporation in the best interests of the shareholders. What is important in this thesis is as to the best way to meet these very interests. On the one hand, directors have an obvious interest in maintaining their

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<sup>63</sup> James F. Cotter & Marc Zenner, “How Managerial Wealth Affects the Tender Offer Process” (1994) 35 *Journal of Finance and Economics* 63 at 86.

<sup>64</sup> Ralph A. Walkling & Michael Long, “Agency Theory, Managerial Welfare, and Takeover Bid Resistance” (1984) 15 *RAND Journal of Economics* 54 at 67.

<sup>65</sup> Jay C. Hartzell, Eli Ofek, & David Yermack, “What’s In It For Me? Personal Benefits Obtained By CEOs Whose Firms Are Acquired”, online: (2000) SSRN: <<http://ssrn.com/abstract=236094>>.

<sup>66</sup> Julie Wulf, “Do CEOs in Mergers Trade Power for Premium?: Evidence from Mergers of Equals” (2004) 20 *Journal of Law, Economics, and Organization* 60.

<sup>67</sup> See Theobald, “Hostile Takeovers”, *supra* note 62 (“As for the shareholders, management’s entrenchment behind its use of defensive tactics arguably decreases the shareholder welfare. Tender offers give the shareholders the opportunity to sell their stock at a premium above the current and arguably true value of the stock, an opportunity that is arguably inalienable. If the board uses its defensive measures, the shareholder loses out on this opportunity” at 28).

positions and prerequisites which generally are threatened.<sup>68</sup> Shareholder choice scholars sustain that this conflict of interest remain too important to allow a board veto and that the shareholders should have the ultimate power to choose whether or not to tender their shares without any board interference. On the other hand, the employment of defensive tactics by corporate directors may appear to be in keeping with their duties to act in the best interests of the shareholders, even when the perpetuation of management control is one of the results. Managerialist school proponents respond that empowering director during a hostile takeover will benefit shareholders more than it costs them; consistent with their role in corporate governance, directors should have almost unrestricted power to choose to accept or defend against a hostile takeover.

### **1.3. The Sources of the Takeover Debate**

The function of corporate law is, for many, to minimize the total agency costs inherent in the relationship between directors and shareholders.<sup>69</sup> Those costs being extrapolated in the event of a hostile takeover – as we have described in the previous sections – it is no surprise that they have been a concern that has been at the heart of the Delaware jurisprudence for years and reduces, in practice, to whether the target's board measures to fend off a hostile takeover are valid. For over twenty-five years,

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<sup>68</sup> See Armour, "Rules for Hostile Takeovers", *supra* note 1 ("A board veto will only work to shareholders' advantage in a takeover situation if the board are properly incentivised to act in shareholders' interests. In situations where the board do not have a sufficient stake in the firm, or are not adequately monitored by outside directors, they may reject worthwhile takeover offers so as to retain their jobs – or accept inferior bids which are coupled with a "bribe" in the form of a handsome retirement package for the board" at 17).

<sup>69</sup> Blair, "Team Production", *supra* note 35 at 248.

many academics have debated this issue; the-more-the-merrier, argued Frank Easterbrook and Daniel Fischel.<sup>70</sup>

Since 1974, the number of hostile takeovers has steadily increased.<sup>71</sup> Yet, they were infrequent in the early 1980s partly because the economy was just emerging from a decade of dismal performance, high interest rates, and the Dow was still below 900.<sup>72</sup> But several political, legal and economic changes have contributed to a boost in the total takeover activity, including:

“The relaxation of restrictions on mergers imposed by the antitrust laws, withdrawal of resources from industries that are growing more slowly or that must shrink, deregulation in the financial services, oil and gas, transportation, and broadcasting markets, and improvements in takeover technology, including a larger supply of increasingly sophisticated legal and financial advisers, and improvements in financing technology such as the strip financing commonly used in leveraged buyouts and the original issuance of high-yield non-investment-grade bonds”.<sup>73</sup>

These changes had positive consequences for the takeover market, as surveys show that roughly 30 percent of the Fortune 500 companies were the target of a hostile takeover bid during the 1980s.<sup>74</sup> It is during this period that private equity funds like Kohlberg Kravis Roberts & Co. started to hostilely purchase large publicly owned corporations, culminating in the famous \$24.8 billion leveraged buyout (“LBO”) of RJR Nabisco, Inc. in 1988. Fuelled by the democratization of finance through the

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<sup>70</sup> Armour, “Rules for Hostile Takeovers”, *supra* note 1 at 7.

<sup>71</sup> For a useful historical account of the development of hostile takeovers, see Carol B. Swanson, “The Turn in Takeovers: A Study in Public Appeasement and Unstoppable Capitalism” (1996) 30 Ga. L. Rev. 943 at 958. See also Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York : Grove Press, 1990) at 596-610.

<sup>72</sup> Ronald Gilson & Reinier Kraakman, “Takeovers in the Boardroom: Burke versus Schumpeter”, online: (2005) SSRN: <<http://ssrn.com/abstract=732783>> [Gilson, “Boardroom”].

<sup>73</sup> Michael C. Jensen, “Takeovers: Their Causes and Consequences” (1988) 2 Journal of Economic Perspectives 21 at 26.

<sup>74</sup> John C. Coates, “Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations ?” (1999) 24 J. Corp. L. 837 at 851.

junk bond market,<sup>75</sup> this wild takeover period transformed collective selling of shares into a real threat to directors' control.

In response, boards of public corporations, assisted by their lawyers, developed innovative strategies to block unsolicited tender offers. These defensive strategies – including poison pills, dual class stock capitalization, etc. – first induced great suspicion among judges,<sup>76</sup> especially since evidence suggests that, at this time, corporate boards have used this power effectively to deter hostile acquirers while encouraging only friendly bids.<sup>77</sup> It is in this context that the takeover debate came out.

#### 1.3.1. Martin Lipton's Provocative Manifesto

As some authors have underlined years later, *Takeover Bids in the Target's Boardroom* was a “call to arms in the defense of an economic order built on the honor, perspicuity, and civility of the officers and directors of America's corporations”.<sup>78</sup> In fact, its author, Martin Lipton, was particularly concerned with the coercive aspect of hostile takeover bids that stormed into the U.S. market. According to him, the ordinary business judgment rule should therefore apply to takeover defenses, in which case they would normally be upheld, absent evidence of gross negligence or self-dealing.<sup>79</sup>

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<sup>75</sup> Gilson, “Boardroom”, *supra* note 72 at 8.

<sup>76</sup> Jennifer Arlen & Eric Talley “Unregulable Defenses and the Perils of Shareholder Choice” (2003) 152 U. Pa. L. Rev. 577 [Arlen, “Perils”].

<sup>77</sup> *Ibid.* at 578 citing Lucian A. Bebchuk, John C. Coates & Guhan Subramanian, “The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy” (2002) 54 Stan. L. Rev. 887.

<sup>78</sup> Gilson, “Boardroom”, *supra* note 72 at 2.

<sup>79</sup> The business judgment rule has long been a part of corporation law in the United States. For a complete definition, see *Cede v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1994) (“[T]he rule operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation. [...] As a rule of evidence, it creates a 'presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company. [...] To rebut the rule, a shareholder plaintiff assumes the burden of

#### 1.3.1.1.The Holy U.S. Economy

Overall, Martin Lipton believed that hostile takeovers were disruptive and threatening for the U.S. economy; he put nothing less than the health of the entire economic system at stake.<sup>80</sup> What he highlighted in his work is that even in the presence of a small suspicion that the inability of companies to defend against takeovers could adversely affect long-term planning and thereby could jeopardize the economy, policy must act in favor of not jeopardizing the economy because “not even a remote risk is acceptable”.<sup>81</sup> To this end, Martin Lipton strongly opposed a neutrality rule; “an empty shareholder choice”, he said, may not interfere with the U.S. economy health:

*“Whether the long-term interests of the nation’s corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of those shares? The overall health of the economy should not in the slightest degree be made subservient to the interests of certain shareholders in realizing a profit on a takeover”.*<sup>82</sup>

To protect this holy U.S. economy and foster business efficiency, Lipton rejected the board neutrality view, as the decision of shareholders is always a “foregone conclusion”.<sup>83</sup> In short, directors are necessary for a serious long-term planning of U.S. economy.

#### 1.3.1.2.The Directors: The Remedy against Cut-throat Capitalism

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providing evidence that directors, in reaching their challenged decision, breached any of the triad of their fiduciary duty of good faith, loyalty or due care” at 360-61).

<sup>80</sup> Gilson, “Boardroom”, *supra* note 72 at 8.

<sup>81</sup> Martin Lipton, “Takeover Bids in the Target’s Boardroom” (1979) 35 Bus. L. Rev.101 at 104-05 [Lipton, “Takeover”].

<sup>82</sup> *Ibid.* at 104.

<sup>83</sup> Gilson, “Boardroom”, *supra* note 72 at 11.

His vision of directors as U.S. economy' guardian is not the only reason for formulating a board veto rule. The major explanation for Martin Lipton's hypothesis seems to be the demoralizing effect that takeovers might have on corporate managers and directors.<sup>84</sup> At the time, he was afraid that, facing this frenetic takeover wave, corporate boards would conclude that the law's ultimate value was both market price and the interests of investors, instead of the responsible treatment of shareholders and non-shareholders stakeholders.<sup>85</sup> In other words, Martin Lipton was concerned about America's top executives losing their vocation as trustees. To him, the board of directors is *the* gatekeeper for significant business transactions.

Therefore, *Takeover Bids in the Target's Boardroom* reiterates at several points that the case for allowing boards to defeat hostile bids does not turn centrally on the consequences for shareholders' interests.<sup>86</sup> Only the board of directors is truly competent to decide against a coercive offer, and especially since the passivity rule, he argued, puts on the company a perpetual "for sale" sign on its lawn.<sup>87</sup> Martin Lipton emphasized that a corporation's board of directors should have a duty to manage actively the business of the company, and that its discretion in doing so should not depend on the nature of the particular issue that is being decided.<sup>88</sup>

In the context of the shareholder/stakeholder debate, the reader may be thinking that Martin Lipton appears to be on the stakeholder model side. We believe however

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

<sup>85</sup> Lipton, "Takeover", *supra* note 81 at 115, 119.

<sup>86</sup> *Ibid.* at 115, 119-20. Martin Lipton still focuses today on directors only and pays little attention about individual control contests and their consequences. See e.g. Martin Lipton, "Pills, Polls, and Professors Redux" (2002) 69 U. Chi. L. Rev. 1037 ("To retain key employees, in the face of the usual rush of head-hunters seeking to steal away the best employees, expensive bonus and incentive plans are put in place. To placate concerned customers and suppliers, special price and order concession are granted. Communities postpone or reconsider incentives to retain facilities or obtain new facilities. The company itself postpones major capital expenditure and new strategic initiatives. Creditors delay commitments and seek protection for outstanding loans" at 1059).

<sup>87</sup> Lipton, "Takeover", *supra* note 81 at 121.

<sup>88</sup> Martin Lipton, "Twenty-Five Years after *Takeover Bids in the Target's Boardroom*: Old Battles, New Attacks and the Continuing War" (2005) 60 Business Lawyer 1369.

that he may not have held such a position in relation to other corporate law issues, such as to whom the directors owe a duty of loyalty more generally. His position was adopted, we believe, only because of what he perceived to be the huge risk to the U.S. economy in the specific context of takeovers. These statements almost reached patriotism about the institution of the board, justifying that “end-running the board is tantamount to a perversion of the corporate republic”.<sup>89</sup> In simple words, Martin Lipton himself does not quite fit into either a stakeholder or shareholder model in general, but was arguing only in the context of the special circumstances of the dangers to the U.S. economy posed by hostile takeovers whereby he definitely adopted a stakeholder view.

#### 1.3.2. Frank Easterbrook and Daniel Fischel Strike Back

At roughly the same time, two academics fought for a different interpretation of directors’ duty, which severely constrained the use of defensive tactics. Without a doubt, Frank Easterbrook and Daniel Fischel provided one of the most aggressive efforts to support the idea that directors must remain totally passive in the face of a hostile takeover bid. In fact, their article *The Proper Role of a Target’s Management in Responding to a Tender Offer*<sup>90</sup> does not only opposed Martin Lipton’s view concerning hostile takeovers, but also takes a strong view of the shareholder choice.<sup>91</sup> Whereas the latter saw evil in non-solicited offers, the former pictured takeovers in general and hostile takeovers in particular, as useful disciplinary tools. They recognized the cognate concern that target directors face a material conflict of interest

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<sup>89</sup> See Martin Lipton & Paul K. Rowe, “Pills, Polls, and Professors: A Reply to Professor Gilson” (2002) 27 Del. J. Corp. L. 1 at 7.

<sup>90</sup> Frank H. Easterbrook & Daniel R. Fischel “The Proper Role of a Target’s Management in Responding to a Tender Offer” (1981) 94 Harv. L. Rev. 1161 [Easterbrook, “Proper Role”].

<sup>91</sup> Their thesis provides the sole ground for barring management’s solicitation of a competing bid for a white knight. See Lucian A. Bebchuk, “The Case for Facilitating Competing Tender Offers” (1982) 95 Harv. L. Rev. 1028 at 1029 [Bebchuk, “Facilitating Competing Tender Offers”].

and will adopt most of the time abuse defensive tactics to seek to “perpetuate [their] control”.<sup>92</sup> They considered that “A manager responsible to two conflicting interests is in fact answerable to neither”,<sup>93</sup> a situation which Professor Roberta Romano considers is liable to result in actions that favor the interests of directors.<sup>94</sup> To avoid any conflicts of interest and the costs associated with them, they formulated their passivity thesis, where target directors are prohibited from defending against a takeover, so that the company’s shareholders would be the ones to decide whether to accept the bid.<sup>95</sup> In layer’s terms, the appropriate role for corporate directors would simply be to stand aside to allow a new team to replace them and make sure that assets are transferred, “in good Chicago fashion, from lower to higher valued uses”.<sup>96</sup>

The two scholars defend their neutrality rule not only because it throws away the costs associated with the conflict of interest, but also because the process of auctioneering, according to them, is ineffective. First, they are concerned that it will severely curtail the search for potential targets.<sup>97</sup> The argument is based on the effects that bidding contests have on the search for takeover targets by prospective acquirers. They affirm that a bidding contest all but denies the first bidder any return on its search, therefore acting as a disincentive for bidders to bid first. Indeed, subsequent potential acquirers, alerted to the target’s existence by the first bidder’s offer, will not bear the “search costs”.<sup>98</sup> As a result, the authors pay little attention to the effect of

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<sup>92</sup> Easterbrook, “Proper Role”, *supra* note 90 at 1175.

<sup>93</sup> *Ibid.* at 1192.

<sup>94</sup> See Roberta Romano, “A Guide to Takeovers: Theory, Evidence and Regulation” (1992) 9 Yale J. On Reg. 119 at 134.

<sup>95</sup> Frank Easterbrook and Daniel Fischel’s approach has antecedents in the 1960s. See Henry Manne, “Mergers and the Market for Corporate Control” (1965) 73 Journal of Policy and Economics 110 [Manne, “Corporate Control”].

<sup>96</sup> Richard A. Epstein, “In Defence of the Corporation” (Paper presented to the New Zealand Business Roundtable in Auckland, Australia, 5 August 2004), available online: <[http://www.nzbr.org.nz/documents/publications/publications-2004/in\\_defence.pdf](http://www.nzbr.org.nz/documents/publications/publications-2004/in_defence.pdf)>.

<sup>97</sup> Easterbrook, “Proper Role”, *supra* note 90 at 1177-78.

<sup>98</sup> Bebchuk, “Facilitating Competing Tender Offers”, *supra* note 91 at 1034-35.



the rule on premiums in the takeovers that do occur.<sup>99</sup> Second, they are concerned about a possible reduction of the number of takeover bids that could arise out of Martin Lipton's hypothesis. Increases in the prices that must be paid for targets, they emphasized, reduce the return on search by prospective acquirers and therefore discourage an activity that could benefit both targets shareholders and the economy: "Even resistance that ultimately elicits a higher bid is socially wasteful because although the target's shareholders may receive a higher price, these gains are exactly offset by the bidder's payment and thus by a loss to the bidder's shareholders".<sup>100</sup> As a result, even directors' resistance that succeeds in triggering a bidding contest and securing a high premium is "counterproductive".<sup>101</sup>

#### **1.4. The Takeover Predicament: Hamiltonians versus Jacksonians**

This new debate, between managerialists and shareholder choice proponents, is a natural progression from the shareholder/stakeholder debate developed above. At first, Martin Lipton argued in favor of stakeholders' interests, whereas Frank Easterbrook and Daniel Fishel opted for shareholders' interests which to them meant necessarily that shareholders should have the final say. Nowadays, both managerialists and shareholder choice proponents would agree with Frank Easterbrook and Daniel Fischel that the relevant interests are those of the shareholders,<sup>102</sup> but the managerialists would disagree with them that the best way to meet these exact interests are by letting the shareholders decide for themselves. In terms of

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<sup>99</sup> Easterbrook, "Proper Role", *supra* note 90 at 1178-80.

<sup>100</sup> *Ibid.* at 1175

<sup>101</sup> *Ibid.* at 1164, 1175-80.

<sup>102</sup> Marcel Kahan & Edward B. Rock, "Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment", online: (2003) SSRN: <<http://ssrn.com/abstract=416605>> ("This school maximizes the authority of the shareholders' representatives while according a narrow role to the shareholders themselves in corporate decision-making" at 10) [Kahan, "Corporate Constitutionalism"].

representation, the new division is embodied by legal academics, on the one hand (the shareholder choice school), and practicing lawyers, judges and legislators, on the other (the managerialist school). A third school of thought exists, but it remains so far irrelevant in both doctrine and the Judiciary.<sup>103</sup>

The managerialist view school posits that corporate boards are in the best position to evaluate whether to accept the bid is in shareholders' best interests, consistent with the board's general role to manage the business. Consequently, the board should have extensive discretion in deciding how to respond to a hostile tender offer, including the right to erect takeover defenses and to "just say no". Against Martin Lipton old arguments – the protection of the U.S. economy – information asymmetries and the pressure to tender problem are the new arguments of the new managerialist proponents, who have been referred to as "Hamiltonian" corporate scholars.<sup>104</sup> At the other end of the spectrum, because they see the board as a device designed to implement the present will of shareholders – and not a device designed to make decisions in the best interests of shareholders<sup>105</sup> – a certain number of academics advocate a shareholder choice, therefore referred to as the "Jacksonians",<sup>106</sup> of which Lucian Bebchuk has undoubtedly become the best representative.

#### 1.4.1. The Managerialist School

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<sup>103</sup> This third school focuses more on non-shareholder constituencies. See e.g. Lawrence A. Mitchell, "A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes" (1992) 70 Tex. L. Rev. 579.

<sup>104</sup> Kahan, "Corporate Constitutionalism", *supra* note 102 at 3.

<sup>105</sup> This is the basis of the reference to Hamilton and Jackson from U.S. history who had different views of the democracy. Jacksonians believed that elected representatives should carry out the wishes of the voters. On the contrary, Hamiltonians believed that elected representatives should make decisions in the interests of voters, even if the voters may disagree with the decision, the argument being that only the elected representative have the necessary information to make an informed deliberation – voters simply ask for whatever they want right now, ignoring long-term consequences or the impact of their decision on other areas of life – so it does not make sense to Hamiltonians to give in to such uninformed decisions.

<sup>106</sup> Kahan, "Corporate Constitutionalism", *supra* note 102 at 4.

According to the Hamiltonians, the board of directors, for the same reasons it is delegated authority to manage the business in the first place, is said to be in a better position than the shareholders to respond to a takeover bid. They acknowledge the shareholder primacy and the reality of agency costs, but believe that the benefits of allowing the directors to decide outweigh these exact costs. Out of all the arguments in favor of a managerial choice, there is one that is redundant: the board has more and better information than shareholders about both the target's business and the bidder's prospects for the company. Directors are better informed; hence they are able to better protect shareholders against inadequate offers. Also, managerialists sustain that the directors' allocation of power over the takeover decision is the only solution to the tender to pressure problem.

#### 1.4.1.1. Information Asymmetries

The most common argument supported by Hamiltonians relates to the information asymmetries that occur between directors and shareholders, which are exacerbated by the takeover bid. In ordinary everyday business transactions, disaggregated shareholders have neither the incentives nor the ability to analyze the information needed to make good business decisions.<sup>107</sup> And even when relevant information is brought to shareholders, coordination and collective decision making problems being too costly if not impossible to solve, it would impair any decision-making; were the shareholders properly informed, they lack the business acumen to make proper decisions concerning their equity and the corporation.<sup>108</sup>

The defenders of the managerialist view basically argue that the same concerns should apply equally in the takeover context. Indeed, that managers might sometimes

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<sup>107</sup> See e.g. Easterbrook, "Economic Structure", *supra* note 48.

<sup>108</sup> *Ibid.*

be better informed has been long accepted by takeover law. In *Paramount Communications, Inc v Time Inc.*, Justice Allen affirmed that “No one, after all, has access to more information concerning the corporation’s present and future condition than managers”.<sup>109</sup> This rationale is quite understandable. Directors most of the time have more expertise and devote more time and effort to assessing the body of information about the company. Also information is complex and shareholders – being dispersed and lacking proper expertise – may not fully get its entire significance. It is especially true concerning the value of the corporation, where directors often have private information that public investors do not possess. As Bernard Black and Reinier Kraakman argued, the target’s “hidden value”, i.e. the target true value, can only be seen by target’s directors and not its shareholders.<sup>110</sup> It is needless to mention that the bidder logically tends to understate the target’s value and target directors’ superior information might indicate shareholders that the target’s value is lower or higher than the level estimated by the bidder. Were the directors’ role completely passive, shareholders might mistakenly accept an inadequate offer. This has been referred to as a “substantive coercion” by Ronald Gilson and Reinier Kraakman.<sup>111</sup> Delaware courts have viewed as plausible and legitimate directors’ concerns that shareholders might mistakenly view as adequate an offer that is, in fact, inadequate according to directors’ superior information.<sup>112</sup> Therefore, shareholders’ interests would be better served by delegating the decision to the board, simply because directors have much greater access to information flows respecting business

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<sup>109</sup> *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994) at 56.

<sup>110</sup> Bernard Black & Reinier Kraakman, “Delaware’s Takeover Law: The Uncertain Search for Hidden Value” (2002) 96 Nw. U. L. Rev. 521 [Black, “Hidden Value”].

<sup>111</sup> Gilson, “Proportionality”, *supra* note 44 at 248.

<sup>112</sup> Lucian A. Bebchuk, “The Case for Increasing Shareholder Power” (2005) 118 Harv. L. Rev. 833 at 881.

prospects and values. The accuracy of this statement is especially verified in the two following scenarios.

#### *1.4.1.1.1. Undervaluation Motive of Hostile Takeovers*

There is a strong basis for supporting target directors' role if the motivation of the bid relies on relevant information regarding the undervaluation of a target company. Corporations that are undervalued by financial markets can be targeted for acquisition by those who recognize this mispricing. The undervaluation hypothesis, which was first affirmed along Manne's concept for market control,<sup>113</sup> posits that a bidder company may launch an acquisition bid for the sole reason that its directors have special information – the inside information – suggesting that the target's stock is currently undervalued. Hence, the acquirer, by paying only a small premium, will be able to buy the company at a price below the true worth to shareholders indicated.<sup>114</sup> If a revaluation is undertaken after the takeover, the process will be accompanied by an increase in the combined stock market value of the target and the acquirer.<sup>115</sup> The managerialist school proclaims that the undervaluation rationale for takeover is a sufficient ground for directors' involvement over the takeover decision; as skilled and experienced people, they are best placed to figure out that the motive of the bidder is based on an undervaluation of the target company.

#### *1.4.1.1.2. The Market Inefficiency*

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<sup>113</sup> Manne, "Corporate Control", *supra* note 95 at 113.

<sup>114</sup> Easterbrook, "Proper Role", *supra* note 90 at 1160.

<sup>115</sup> Sanford J. Grossman & Oliver D. Hart, "the Allocational Role of Takeover Bids in Situations of Asymmetric Information" (1981) 36 *Journal of Finance* 253.

The uncertainty regarding stock market efficiency has always been a concern in takeover law.<sup>116</sup> If markets are not efficient, meaning that investors cannot really outguess market prices by using public information, the market price may deviate from the target's true value.<sup>117</sup> It is a concern in the takeover debate since there is an obvious interaction between financial market efficiency and the appropriate legal regime for governing takeover defenses. Indeed, it has been argued that the policy choice between board neutrality and board discretion depends on the relative efficiency of capital markets. Based on a rejection of the efficiency of capital markets hypothesis – therefore a conviction that stock prices might often deviate from fundamental values – Hamiltonians believe that boards would decide better whether any given offer is worth accepting or not. There are indeed good reasons to doubt in practice on the extent to which market prices generally reflect fundamental values. Not all take the position that the target company's current market price is a sufficiently good metric of the company's value. For these authors, had stock markets been “informationally efficient”, they would not do a good “fundamental” job of pricing target companies.<sup>118</sup> The stock market's inefficiency undermines the passivity approach of Frank Easterbrook and Daniel Fischel, who believe that a takeover at “a premium over the pre-bid market price is bound to increase shareholder wealth and

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<sup>116</sup> The debate on the efficiency of capital market is still topical. See e.g. Lynn A. Stout, “The Mechanisms of Market Inefficiency: An Introduction to the New Finance” (2003) 28 J. Corp. L. 635; see also Donald C. Langevoort, “Taming the Animal Spirits of the Stock Markets” (2002) 97 Nw. U. L. Rev. 135.

<sup>117</sup> For a good definition of the market efficiency theory, see Burton Malkiel, “Efficient Market Hypothesis” in Peter Newman, Murray Milgate & John Eatwell, eds. *New Palgrave Dictionary of Money and Finance Markets* (London: MacMillan, 1992) (“A capital market is said to be efficient if it fully and correctly reflects all relevant information in determining security prices. [...] Formally, the market is said to be efficient with respect to some information set [...] if security prices would be unaffected by revealing that information to all participants. Efficiency with respect to an information set [...] implies that it is impossible to make economic profits by trading on the basis of [that information set]” at 121).

<sup>118</sup> Jeffrey N. Gordon & Lewis A. Kornhauser, “Efficient Markets, Costly Information and Securities Research” (1985) 60 N.Y.U.L. Rev. 761 at 786; Donald L. Langevoort, “Theories, Assumptions and Securities Regulation: Market Efficiency Revisited” (1992) 140 U. Pa. L. Rev. 851 at 912-20.

efficiency”.<sup>119</sup> The recent burst of the Internet bubble has provided a perfect illustration of the discrepancies that occur between stock prices and fundamental values. Professor Tyler Theobald worries that giving shareholders the power to decide over takeover decisions would miss the purpose: “More alarming would be a reoccurrence of the tech-stock bubble of 1999-2000, where a company forced to look only at short-term gain may have been pressured into allowing a takeover by an extremely overvalued and doomed company”.<sup>120</sup> Therefore, Hamiltonians believe that large externalities in the takeover context justify board intervention; board veto or its ability to use defensive measures would thus address situations in which a company’s stock is trading at a depressed level below its fundamental value.<sup>121</sup>

#### 1.4.1.2. The Pressure to tender Problem

Granting boards with a veto power may also possibly address the problem according to which shareholders, facing a takeover bid, might be pressured to tender their shares.<sup>122</sup> It is commonly argued that, in the absence of directors’ role, shareholders will tender their shares even though the takeover is not in their best interest just to avoid a possible lower post-takeover value of their non tendered shares. Professor Lucian Bebchuk provides a short yet great explanation of the pressure-to-tender problem:

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<sup>119</sup> Easterbrook, “Proper Role”, *supra* note 90 at 1173-74.

<sup>120</sup> Theobald, “Hostile Takeovers”, *supra* note 62 (“The danger of [recognizing market efficiency] is evident when one looks at the market occurrences over the last two decades. First, any company undervalued in the 1980’s would have been bought out for a slight premium, which would have led those companies and their shareholders to miss out on the long term 1000% increase in stock market value since then [...] It is these dangers which supporters seek to prevent by allowing companies to consider long-term goals and to protect shareholders from a short-term gain, which ends up being an illusion” at 26).

<sup>121</sup> Lipton, “Takeover”, *supra* note 81 at 108.

<sup>122</sup> For a full account of this problem, see Lucian A. Bebchuk, “Toward Undistorted Choice and Equal Treatment in Corporate Takeovers” (1985) 98 Harv. L. Rev. 1695 at 1717-33 [Bebchuk, “Toward Undistorted Choice”].

“In deciding whether to tender, each shareholder will recognize that its decision will not determine the fate of the offer. The shareholder will therefore take into account the scenario in which the bid is going to succeed regardless of how the shareholder acts. Whenever the expected post-takeover price of minority shares is lower than the bid price, the scenario will exert pressure on the shareholder to tender. As a result, shareholders might tender, and a takeover might occur, even if most shareholders do not view a takeover as being in their collective interest”<sup>123</sup>

Any coordination among shareholders is either not possible or very costly. Therefore each shareholder does not know whether the other shareholders are going to accept the offer or not, and given that if the takeover succeeds, shareholders who did not tender might remain with undervalued shares in the hands, the best option would seem to tender. In the end, a target shareholder might well tender his/her shares even if he/she views the offered acquisition price as lower than the value of the independent target. The pressure comes from the buyer’s contractual freedom to formulate the offer as it wishes. The general technique is to offer a high price to some shareholders in order to gain *de facto* control and thus to put pressure on the remaining shareholders to accept a lesser offer. The typical case of pressure to tender happens during partial bids – for less than 100% of the shares – a first partial bid followed by a 100% bid at a lower price. These bids are rare in Europe, because most member states, and now the Takeover directive, contain a mandatory bid rule.<sup>124</sup> However, the doctrine consents that almost all bids have coercive effects, although the pressure to tender is most visible in such cases. Lucian Bebchuk explained that, as long as the expected post-takeover value of minority shares is lower than the bid price, bids should be considered as coercive, even all cash bids with the duty to

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<sup>123</sup> Lucian Bebchuk, “The Case against the Board Veto in Corporate Takeovers” (2002) 69 U. Chicago L. Rev. 973 at 981 [Bebchuk, “Board Veto”]; See also Bebchuk, “Toward Undistorted Choice”, *supra* note 122 at 1742-1743.

<sup>124</sup> Further discussion of the European directive will be found in Chapter 3, below.



purchase the remaining shares at the same price.<sup>125</sup> Some others however take the opposite view, arguing that all cash bids are to be considered as coercive, except the case when the acquirer must purchase the remaining shares at the same price of the bid.<sup>126</sup>

#### 1.4.2. The Shareholder Choice School

The shareholder choice school is a non homogenous doctrinal trend which has become more sophisticated in the last decade. Whereas Frank Easterbrook and Daniel Fischel argued for a strong form of shareholder choice – a pure passivity role of directors – the school has however softened its position more recently, with orientations towards limited board actions whereby the board would only serve as a shareholders’ bargaining agent by ensuring that the target shareholders’ tender decision is undistorted, or by seeking better deals than the hostile bid. Ronald Gilson noted that every single proponent of this school however shares one important point, i.e. that “There is no coherent justification for allowing target management to engage in defensive tactics that may deprive shareholders of the opportunity to tender their shares”.<sup>127</sup> In addition to that, another unifying and convincing argument against board veto falls under the banner of the agency theory. As we have seen before, since the interests of the managers are susceptible to divert from those of the shareholder as hostile acquisitions most of the time presage managerial turnover, directors can become consumed with self-preservation, either by resisting hostile deals altogether or favouring friendly acquisitions that would protect them. As a result, even though Jacksonians admit the desirability of professional management in ordinary business

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<sup>125</sup> Bebchuk, “Toward Undistorted Choice”, *supra* note 122 at 1735-42.

<sup>126</sup> Gilson, “Proportionality”, *supra* note 44 at 254.

<sup>127</sup> Ronald J. Gilson, “Seeking Competitive Bids versus Pure Passivity in Tender Offer Defense” (1982) 35 Stan. L. Rev. 51 at 57.

transactions, they argue that in the context of a tender offer the agency costs of professional management exceed its benefits.

#### 1.4.2.1. Hostile Takeovers as Disciplinary Devices

It is obvious that hostile takeovers of other companies are prepared and executed for a variety of reasons. The doctrine in this area of takeover motives is abundant, and to some extent, controversial.<sup>128</sup> Friedrich Trautwein identified seven theories of motives: efficiency theory, monopoly theory, valuation theory, empire-building theory, process theory, raider theory and disturbance theory.<sup>129</sup> We have seen that a bid may also be motivated by undervalued information on the target company. A recurrent yet arguable<sup>130</sup> motive for hostile takeover is the prospect of increasing the target's profits by replacing its management. Some companies perform poorly because they are inefficiently managed. Therefore, takeovers would provide a "pure" corporate governance function: they would act as a disciplining device because the new management may be more dedicated to profit-maximization and less inclined to pursue its own interests, thereby reducing the level of agency costs. At the end of the

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<sup>128</sup> The explanation of takeovers was first suggested by Manne. See Manne, "Corporate Control", *supra* note 95 at 113. See more recently Roberta Romano, "A Guide to Takeovers: Theory, Evidence and Regulation" (1992) 9 Yale J. On Reg. 119 at 125.

<sup>129</sup> Friedrich Trautwein, "Merger Motives and Merger Prescriptions" (1990) 11 Strategic Management Journal 283.

<sup>130</sup> Importantly enough, the disciplinary rationale for takeovers is not unanimously upheld by academics' circles for several reasons. First, to some scholars, there is little evidence of poor target performance before the disciplinary bid. Julian Franks and Colin Mayer argued that there is little evidence that takeovers in the United States and the United Kingdom are motivated by poor performance prior to the takeover bid; to the contrary, they are primarily motivated by other objectives, such as changes in corporate strategy, or rent seeking activity. See Julian Franks & Colin Mayer, "Hostile Takeovers and the Correction of Managerial Failure" (1996) 40 Journal of Financial Economics 163. Although there are relatively few overtly hostile offers compared to friendly deals, many friendly deals may be agreed under the Damocles' sword of a hostile offer threat. Even in the context of a friendly bid, target directors often find themselves out of the job. See Robert W. Hamilton & Richard Booth, *Corporate Finance Cases and Materials* 3rd ed. (New York: West Group, 2001) at 768. In the end, even though it is difficult to tell the impact of hostile takeovers as a disciplinary force on directors, the shareholder choice school appropriated the disciplinary device rationale of the hostile takeover to formulate its arguments against board veto.

day, this market for corporate control would discipline a corporation's board to run the business so as to eventually maximize the company's value:

“Takeovers are a means for ousting managers who are either inefficient, or whose strategies have failed to create sufficient shareholder value with the resources of the firm. This results in a lack luster share price, low profitability, poor long-term performance and prospects. This is where the bidder management feels the target is presently valued at a discount to its real underlying worth”.<sup>131</sup>

The market for corporate control is a major component of the managerial labor market, in which managers compete for the rights to manage corporate resources.<sup>132</sup>

The disciplinary theory is consistent with the evidence that successful tender offers are accompanied by an increase in the combined stock market value of the acquirer and the target.<sup>133</sup>

It would be *a priori* totally paradoxical to empower directors with takeover defenses if they poorly administer the company; if the only purpose of the hostile takeover is to oust undisciplined directors, there is no reason to let these very directors the right to oppose the very bid or erect defensive measures. Indeed, if we assume that the disciplinary theory benefits shareholders' interest, Lucian Bebchuk on the contrary clearly demonstrated that a board veto over a tender offer diminishes the disciplinary force that a takeover threat can exert on incumbents, resulting in “poorer management performance, lower profit margins, less return on equity, slower sales growth, and an overall reduction in firm value”.<sup>134</sup>

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<sup>131</sup> Mahendra Raj & Michael Forsyth, “Management Motive, Shareholder Returns, and the Choice of Payment: Evidence from the UK”, online: (2004) American Journal of Business: <<http://www.bsu.edu/mcobwin/majb/?p=103>>.

<sup>132</sup> See e.g. Michael C. Jensen & Richard S. Ruback, “The Market for Corporate Control: The Scientific Evidence” (1983) 11 Journal of Financial Economics 5.

<sup>133</sup> Kenneth J. Martin & John J. McConnell, “Corporate Performance, Corporate Takeovers and Management Turnover” (1991) 46(2) Journal of Finance 671.

<sup>134</sup> Lucian Bebchuk, “The Case for Increasing Shareholder Power” (2005) 118 Harv. L. Rev. 833 at 849.

#### 1.4.2.2. The Takeover Decision, A Shareholder “Sacred Space”

Some Jacksonians endeavor to justify a shareholder choice “in an effort to clearly carve out that part of the decision-making space in corporate governance that is left to shareholders”.<sup>135</sup> Shareholders should have the ultimate power to determine the direction of the corporation because they are entitled to elect the directors. As Lucian Bebchuk affirmed, “one of the principal reasons the board is afforded broad discretion to manage the business in the first place is because the shareholders retain residual control rights which give them the authority to remove directors by voting or to sell”.<sup>136</sup> In other words, the shareholders’ oversight is viewed as crucial to the legitimacy of directors’ power. Shareholders’ voting should not be understood as an integral aspect of the corporate decision-making structure, but more as an accountability device of last resort to be used from time to time. This idea was reflected in *Blasius Indus. v. Atlas Corp.*, where the court set forth that “The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests”.<sup>137</sup> Therefore, maintaining a proper balance in the allocation of power between the stockholders’ right to elect directors and the board of directors’ right to manage the corporation is dependent upon “the stockholders’ unimpeded right to vote effectively in an election of directors”.<sup>138</sup> And, as Robert Clark observed, the proper way in which shareholders’ voting rights are used to hold corporate directors and officers accountable is not through the exercise of individual voting decisions but rather collectively in the context of a takeover.<sup>139</sup> Based on this

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<sup>135</sup> Robert B. Thompson & Gordon D. Smith, “Toward a New Theory of the Shareholder Role: ‘Sacred Space’ in Corporate Transactions”, 80 Tex. L. Rev. 261 at 265 [Thompson, “Sacred Space”].

<sup>136</sup> Bebchuk, “Board Veto”, *supra* note 125 at 996; Gilson, “Structural Approach”, *supra* note 10 at 848-52.

<sup>137</sup> *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) at 659.

<sup>138</sup> *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003) at 1127.

<sup>139</sup> Robert C. Clark, *Corporation Law* (Little Brown: A. A. Balkema, 1986) at 95.

assumption, Robert Thompson and Gordon Smith affirmed that there is a space, so called “sacred space”, in which shareholders should exercise inviolate rights to vote and sell and which would allow shareholders to “initiate action that would put the company up for sale, leaving it to the board to conduct the auction”.<sup>140</sup> The argumentation is remarkable and requires some consideration in this section; the best way to study it is to start with the devices Robert Thompson and Gordon Smith enacted to justify their hypothesis.

First, the authors declared that the “sacred space” would embody the structure established by positive corporate law that shareholders participate directly in core governance decisions;<sup>141</sup> as it is visible in the statutory provisions specifying large corporate decisions like mergers that are not left to the directors alone, but must have the approval of shareholders.<sup>142</sup> The sacred space, they argue, is a necessary counterbalance to the deficiencies in director decision making; shareholder decision making has a venerated place in corporate governance. On this notion of balance of powers, Professor Troy Parades recognizes that shareholder choice proponents agree on the special nature of the takeover decision, which “presents ownership issues that fall within the sphere of shareholder control”.<sup>143</sup> Allocating residual control rights to the board would upset the equilibrium balance of power that exists in corporations and would undermine the legitimacy of the authority the board has. He explains that, “coming full circle to Berle and Means, the law is responsible for ensuring that directors do not wrest from shareholders their rights to vote and sell”.<sup>144</sup> Directors

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<sup>140</sup> Thompson, “Sacred Space”, *supra* note 135 at 308.

<sup>141</sup> *Ibid.* at 315.

<sup>142</sup> See e.g. Ira M. Millstein & Salem M. Katsh, *The limits of Corporate Power – Existing Constraints on the Exercise of Corporate Discretion* (New York: MacMillan Publishing Co., Inc., 1981) (“In all states, shareholder approval is required to merge the corporation into or consolidate it with another corporation, to sell all or substantially all of its assets, to dissolve the corporation, to reduce its capital, or to amend its certificate of incorporation” at 6).

<sup>143</sup> Troy, “Control”, *supra* note 48 at 122.

<sup>144</sup> *Ibid.* at 123.

should be precluded from interfering with shareholders' exercise of their control rights, just as shareholders should not interfere with the board's efforts to run the company: "When directors intentionally act to thwart the right of the shareholders to remove them at the polls, they intrude upon basic statutory rights of the shareholders and upset the careful balance of power created by the Delaware General Corporation Law".<sup>145</sup> The shareholders' decision-making is crucial to the equilibrium. In layer's terms, shareholders should be allowed to make "sell" decisions just like they are allowed to make "buy" decisions.<sup>146</sup>

Second, the authors explain that the sacred space would not necessarily mean that shareholders should be entitled to make an immediate and direct decision regarding every proposed change in control.<sup>147</sup> They recognize that shareholders have a specific role in corporate decision-making, but that this role is limited by the statutorily assigned functions of voting, selling, and suing.<sup>148</sup> The board should serve as the shareholders' bargaining agent by remedying distortions in the target shareholders' tender decision or by seeking better deals than the hostile bid, "in effect replicating the outcome that would result if there were a sole owner of the target".<sup>149</sup> This second device shows how shareholder choice proponents turned away Frank Easterbrook and Daniel Fischel's strict neutrality rule. Here, Robert Thompson and Gordon Smith expressly recognize a directors' role in the face of a bid, i.e. conducting the auction of the company.<sup>150</sup>

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<sup>145</sup> William T. Allen & al., "Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law" (2001) 56 Bus. L. Rev. 1287 at 1311 cited in Troy, "Control", *supra* note 48 at 123.

<sup>146</sup> Troy, "Control", *supra* note 48 ("If stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time for deliberation has been afforded." at 147).

<sup>147</sup> Thompson, "Sacred Space", *supra* note 135 at 317.

<sup>148</sup> *Ibid.*

<sup>149</sup> *Ibid.*

<sup>150</sup> *Ibid.* at 308.

#### 1.4.2.3. The Creation of an Undistorted Shareholder Choice

Aiming at countering the managerialist argument regarding information asymmetries, proponents of the shareholder choice have focused on the ways to improve the quantity and the quality of information transmitted to shareholders. The ultimate objective is to enable widespread shareholders to make perfectly informed choice and therefore circumspect the directors authority. In fact, Jacksonians recognized that control over the decision making regarding tender offers should devolve to shareholders if, and to the extent that, shareholders can be relied upon to make informed judgments concerning tender offers. They argue that although target shareholders are often less informed than management about the target's value, target shareholders do not seem to be a group for which paternalistic hands-tying is warranted.<sup>151</sup> Accordingly, some Jacksonians have developed mechanisms to allow shareholder to make informed choice over the takeover decision. Lucian Bebchuk argued that once a so called "undistorted shareholder" choice is guaranteed, which can be done by making it necessary for hostile bidders to win a vote of shareholder support,<sup>152</sup> boards veto power over offer tenders becomes irrelevant in takeover law.<sup>153</sup> To him, ensuring an undistorted choice is clearly superior to a regime

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<sup>151</sup> See *Basic, Inc. v Levinson*, 485 US 224 (1988) ("There is little reason to view shareholders as unaware of this state of affairs or as likely to ignore it out of hubris, irrationality, or otherwise" at 234).

<sup>152</sup> For a clear definition of the distorted choice, see Theobald, "Hostile Takeovers", *supra* note 62 ("The distorted choice occurs when deciding whether or not to tender shares. The theory posits that a shareholder will tender her shares, even though the takeover is not in her best interest because she fears that if the takeover is successful, the post-takeover value of her untendered shares will be significantly less than the bid price. This pressure to tender is detrimental to the shareholder and the corporation because tendering out of fear instead of tendering to replace poor or inefficient management is a waste of corporate assets and is contrary to the idea that takeovers are desirable only when they create efficiency gains" at 30).

<sup>153</sup> The concept of undistorted choice in the face of an acquisition offer was first introduced and analyzed by Professor Bebchuk in Bebchuk, "Toward Undistorted Choice", *supra* note 122. See in particular Bebchuk, "The Case Against Board Veto in Corporate Takeovers", *supra* note 32 at 981-86.

facilitating the success of any premium offer, or to a regime “enabling the target’s management to determine the success of acquisition attempts”.<sup>154</sup>

So what is an “undistorted choice”? The academic defines it as a “Choice reflecting shareholders’ judgment on whether acceptance of the acquisition offer would serve their collective interest”.<sup>155</sup> In other words, an acquisition will succeed only if shareholders, and shareholders only, “undistortedly” view the offered acquisition price as higher than the target’s independent value. Such an undistorted choice would be secured by shareholder vote.<sup>156</sup> Concerning coercive bids, Lucian Bebchuk suggests a “voting or vote-like mechanism” as the best means of addressing the pressure to tender: two questions would be posed of the shareholder: firstly, whether he/she would like the takeover to occur; secondly, whether he/she would like his shares to be acquired in the event that a takeover does take place.<sup>157</sup> Such a system would only allow the bidder to get control where majority support is secured and, in the event of a successful takeover, would guarantee that all shareholders wishing to tender received a fair proportion of the total acquisition price.<sup>158</sup> Consequently, the undistorted shareholder choice should enable shareholders to act in the same way as a sole owner of an asset would: the guiding principle for corporate acquisitions should parallel the principle followed in the sole owner context.<sup>159</sup> Given that there is virtually a sole owner acting and that any acquisition of assets is conditional on the owner’s consent, such acquisitions will consequently take place if and only if the offered acquisition price is viewed by the owner as higher than the value to himself retaining his assets. Therefore, the undistorted choice objective

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<sup>154</sup> Bebchuk, “Toward Undistorted Choice”, *supra* note 122 at 1720.

<sup>155</sup> *Ibid.* at 983.

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

<sup>157</sup> *Ibid.* at 982.

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

<sup>159</sup> Lucian A. Bebchuk, “The Sole Owner Standard for Takeover Policy” (1988) 17 J. Legal Stud. 197 at 198.



suggests that the shareholders' judgment is the norm of the deal, "since the majority is more likely to be right than the minority in its assessment of the shareholders' value-maximizing course of action".<sup>160</sup>

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<sup>160</sup> *Ibid.*

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In Chapter 1, we analyzed the fundamental issue regarding the appropriate role of directors in response to hostile takeover attempts. Attempts to resolve this problem gave rise to two schools of thought. On the one hand, the board defense approach holds that shareholders are unable, due to limited experience, collective action and coordination problems, to make informed choices in the takeover context. Therefore, boards should be permitted to erect defenses on the grounds that they are better placed to protect the interests of shareholders. On the other hand, the shareholder choice perspective holds that boards are self-interested in their response to takeover bids: shareholders are accordingly best positioned to take the ultimate decision in a takeover bid.

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## Chapter 2

### 2. The Takeover Debate in the Real World: U.S. versus Europe

In this chapter, we offer a comprehensible, practical and comparative outlook of the takeover debate. The U.S. takeover regulation has adopted features of the managerialist approach by allowing broad powers to corporate boards. Indeed, Delaware courts have generally emphasized that the company is *always* managed by or under the control of its directors, therefore clearly rejecting Frank Easterbrook and Daniel Fischel's approach. This being said, the Judiciary has subjected defensive measures to a heightened form of judicial review, affirming that there is no absolute power given to the board (2.1.). On the other side of the Atlantic, we see a stingingly different picture. Contrary to the U.S. system, the European system approves and follows the thoughts of shareholder choice academics. In reality, the European Takeover directive, following the model already enforced in the U.K. for almost forty years in most of the member states, has explicitly rejected managerial discretion in favor of a shareholder-oriented strategy – the neutrality rule – for regulating takeovers (2.2.).

#### 2.1. The U.S. Managerial View

In the U.S., the source of corporate boards' powers comes from state statutes, making directors the sole decision-making authority regarding the business of the

corporation.<sup>161</sup> The control of these very powers lies in the legal deference by courts under the business judgment rule set forth in section 141 of the Delaware General Corporate Law code (“DGCL”).<sup>162</sup> However, courts have refused to apply such deference to the realm of hostile takeovers and the board’s ability to use defensive measures; instead, they adopted what could be described as an enhanced business judgment rule, which shows obvious signs of the managerialist school (2.1.3.) even though its boundaries still remain blurred (2.1.1.). Under these circumstances, it is remarkable that the Delaware court of Chancery is pushing towards the adoption of a shareholder choice oriented policy (2.1.2.).

#### 2.1.1. Delaware Case law: A Lack of Jurisprudential Purity

Delaware case law could be seen, *prima facie*, as quite orthodox. Indeed, it does not hold any “sensible allocation of power between managers and shareholders”<sup>163</sup> and allows managers to entrench themselves; target directors have broad discretion to adopt defensive tactics under *Unocal* and *Paramount*. However, once the company is for sale and/or there is a change of control pending, board’s *Revlon* duties are said to be triggered, demanding directors to get the best deal for their shareholders. Therefore, these cases are also an illustration of the division between the stakeholder/shareholder camps. The lack of purity of U.S. jurisprudence, as we will see in this section, seems to reside in courts’ incapacity to decide why the decision should be granted to directors; is it to protect the interests of the corporation (which could arguably lean

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<sup>161</sup> See Christin Forstinger, *Takeover Law in EU and the USA: A Comparative Analysis* (Förlag: Kluwer Law International, 2002) at 22 [Forstinger, “Takeover Law”].

<sup>162</sup> *Delaware General Corporation Law* §141(a) (2001). For a short definition of the business judgment rule, see *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (describing the business judgment rule as the “rebuttable presumption that in making a business decision the directors of a corporation 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” at 812).

<sup>163</sup> Black, “Hidden Value”, *supra* note 110 at 521.

more towards a stakeholder model) or the interests of shareholders (which is absolutely a shareholder model)? U.S. courts have absolutely refused to clearly determine a position, stating instead that directors have an obligation to act in the interests of both the corporation and the shareholders.<sup>164</sup>

#### 2.1.1.1. *Unocal*, the Landmark Decision

*Unocal*<sup>165</sup> is said to be “The most innovative and promising case in our recent corporation law”.<sup>166</sup> Certainly, the case was the first to announce an intermediate standard that sought to differentiate good and bad defensive tactics in the hostile takeover context. In 1985, Mesa Petroleum (“Mesa”) made an unsolicited offer to acquire roughly 37% of Unocal’s outstanding shares in a two-tier all cash tender offer. The Unocal board of directors rejected Mesa’s bid, convinced that it was both coercive and inadequate.<sup>167</sup> The board believed that Mesa’s financing was coercive because it would have coerced shareholders to tender because Mesa would offer significantly less holdouts after the successful takeover. Also, Mesa had a reputation of being a “green mailer”, i.e. holding blackmail policies.<sup>168</sup> To counter the hostile bid, Unocal directors issued a self-tender offer to buy back Unocal stock at a price higher than the one offered by Mesa.<sup>169</sup> In other words, Unocal board made its own defensive tender offer for Unocal shares in order to discourage Mesa to raise its bid.

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<sup>164</sup> The debate over the social role of the corporation remains unresolved both in theory and in practice. See Leo E. Strine, “The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any ‘There’ There?” (2002) 75 S. Cal. L. Rev. 1169 at 1170-73.

<sup>165</sup> *Unocal Corp. v. Mesa Petroleum*, 493 A 2d 946 (Del. 1985) [*Unocal*].

<sup>166</sup> *City Capital Assoc. L.P. v. Interco Inc.*, 551 A 2d 787 (Del. Ch. 1988) at 796 [*Interco*]. See also see Ventoruzzo, “Contrasts”, *supra* note 7 (“This case was particularly significant because it represented a recognition that the inherently self-interested nature of defensive measures required a difference balance for fiduciary duties are evaluated in other contexts” at 26).

<sup>167</sup> *Unocal*, *supra* note 165 at 956.

<sup>168</sup> *Ibid.* at footnote 13i. In short, green mailing can be defined as a technique by which an insufficient offer is made in order to force the target company to buy back the potential acquirer’s stock at a premium to prevent them from taking control of the company with the undervalued tender offer.

<sup>169</sup> *Ibid.* at 949, 954.

Realizing that it could not achieve its plans, Mesa filed suit in order to challenge the discriminatory nature of Unocal's self-tender. The issue was described by the Delaware Supreme Court as follows: "Did the Unocal board have the power and duty to oppose a takeover threat it reasonably perceived to be harmful to the corporate enterprise, and if so, is its action here entitled to the protection of the business judgment rule?"<sup>170</sup>

The court first recognized that the question of a target board's proper role in a takeover is about the nature of its control, because if the board does not have authority to act, "all other questions [including whether or not the board acted in accordance with its fiduciary duties] are moot".<sup>171</sup> The rationale of the court is based on the broad powers that section 141(a) of the Delaware General Corporate Law code grants to the directors; this "large reservoir of authority", the court said, includes the power to adopt defensive tactics to fend off hostile bidders.<sup>172</sup> Statutory powers have to be expanded to the board's authority to merely protect the corporate entity and "shareholders from a reasonably perceived threat irrespective of its source";<sup>173</sup> with regards to such statement, there is no doubt about the position of U.S. jurisprudence on the stakeholder/shareholder debate. This being said, the only remaining question was to assess the standard of review for defensive tactics by which director action is to be measured.

The court recognized that directors fill an important role by acting as representatives of shareholders, but also that the directors are not completely free of conflicts.<sup>174</sup> In fact, the judge keeps referring to the interests of both the corporation and the shareholders, without saying these are one and the same, thus raising the

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<sup>170</sup> *Ibid.* at 953.

<sup>171</sup> *Ibid.*

<sup>172</sup> *Ibid.*

<sup>173</sup> *Ibid.* at 954.

<sup>174</sup> *Ibid.*

possibility (or leaving the possibility open) that they are not the same thing. On the one hand, the Court affirmed that passivity would arguably run afoul of the directors' duty to protect the company and to run the business so long as they are in office.<sup>175</sup> On the other hand, the presence of inherent conflicts of interest made the court unwilling to jump immediately to the business judgment rule deference: "A corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available".<sup>176</sup> The court makes a statement consistent with the shareholder camp and the problems identified by the agency theory. But then it refers to the duty to protect the company, showing the difficulty the court has with identifying to whom the director owes a duty in the context of the shareholder/stakeholder debate.

Eventually, an intermediate standard of review, later labeled as the *Unocal* test, was created for determining whether the business judgment rule applies, the animating force of it being "the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders".<sup>177</sup> With *Unocal*, defensive tactic decisions have to be scrutinized under an enhanced business judgment rule, which requires the directors to show that through good faith and reasonable investigation (i) they reasonably perceived a threat to the corporate entity by another person's acquisition of ownership and (ii) their response was proportional to the perceived threat.<sup>178</sup> On the first prong, while the defendants are required to show that "they had reasonable grounds for believing there was a danger to corporate policy and effectiveness," the *Unocal* court stated that this burden of proof was

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<sup>175</sup> *Ibid.* at 955.

<sup>176</sup> *Ibid.* at 950.

<sup>177</sup> *Ibid.* at 954.

<sup>178</sup> *Ibid.* at 955 (examples of threats include but are not limited to: inadequacy of the bid price, the nature and timing of the offer, the impact on non-shareholder constituencies, and the quality of securities offered as consideration).

“satisfied by a showing of good faith and reasonable investigation”.<sup>179</sup> In other words, the parties would be debating the same issues that would arise under the business judgment rule. The second prong is more controversial as it seems to require a substantive judgment by the court, something completely missing from most cases decided under the business judgment rule.<sup>180</sup> As a result, the court found the Unocal board to have met this enhanced scrutiny because of both the nature and price of Mesa’s offer and its reputation for greenmailing.<sup>181</sup>

Therefore, *Unocal* establishes broad judicial respect for the board’s authority to manage the corporation’s business and affairs. Some authors underlined that:

“The rule is designed to furnish greater flexibility to managers in responding to hostile takeovers, where such bids are likely to harm the company, whilst ensuring that they remain bound by their fiduciary duty to shareholders and act proportionately, although the legislation always refers to the duty owed to the corporation, not to the shareholders”.<sup>182</sup>

Others describe it as a compromise between the “two more extreme approaches”, i.e. the traditional business judgment rule and the strict neutrality rule.<sup>183</sup> On the stakeholder/shareholder debate, *Unocal* does not convey a clear position; *Revlon* however attempts to give one.

#### 2.1.1.2. The *Revlon* Duties

In contrast with *Unocal*, the Delaware Supreme Court affirmed in *Revlon*<sup>184</sup> that the board’s authority is restrained when a takeover bid primarily raises issues implicating the control rights of shareholders. Here, the Delaware Court nullified the

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<sup>179</sup> *Ibid.*

<sup>180</sup> Further discussion of the second prong will be found in section 2.1.2.1.

<sup>181</sup> *Unocal*, *supra* note 165 at 946.

<sup>182</sup> Ventoruzzo, “Contrasts”, *supra* note 7 at 26.

<sup>183</sup> Kirchner, “European Modified Business Judgement Rule”, *supra* note 11 at 13.

<sup>184</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A. 2d 173 (Del. 1986) [*Revlon*].



defensive action of the target board and made clear that although broad, directors' authority is not absolute. It announces a new standard for the judicial review of directors' conduct holding that when the "sale" or the "break-up" of a corporation becomes inevitable, board's duty changes from defenders of the corporation to auctioneers charged with getting the best price for the target shareholders. To tie back to our comments on *Unocal*, the court is trying to resolve in *Revlon* the ambiguity by saying that in a certain set of circumstances, the directors owe a duty to the shareholders alone, instead of simply referring to "the corporation and its shareholders". Indeed, when the corporation is obviously for sale, agency costs are not ambiguous, and directors' duties can only be to the shareholders.

At the outset was a fiery bidding contest between Pantry Pride and Forstmann Little to acquire Revlon. The public auction began in August 1985, when Pantry Pride made a hostile bid for Revlon, initially at \$47.50 per common share and subsequently raised to \$53 per share,<sup>185</sup> which the Revlon board felt was too low.<sup>186</sup> In response to these successive bids, Revlon knew that its sale was inevitable and sought out a white knight, which appeared to be Forstmann for \$56 per share in cash.<sup>187</sup> Soon after, Pantry Pride countered with a \$56.25 per share offer.<sup>188</sup> The board, willing to keep Pantry Pride at bay, adopted defensive tactics, including lock-up options in Revlon assets granted to Forstmann, a no-shop provision, and a break-up fee unanimously approved by the Revlon board.<sup>189</sup> These provisions were effectively bidding even though the Pantry Pride bid was higher.<sup>190</sup> When the suit was filed, Pantry Pride's bid

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<sup>185</sup> *Ibid.* at 177.

<sup>186</sup> *Ibid.* at 176-80.

<sup>187</sup> *Ibid.* at 178.

<sup>188</sup> *Ibid.*

<sup>189</sup> *Ibid.* at 178-79. A lock-up option is an option to buy key assets of a target company, which is generally given to a "white knight" or preferred purchaser in order to deter a hostile bid. A no-shop provision inhibits board's ability to negotiate with other potential bidder, unless that person has made a superior offer.

<sup>190</sup> *Ibid.* at 176-80.

was \$58 per share whereas Forstmann Little's bid was \$57.25. Under these circumstances, Pantry Pride filed suit in order to challenge the Revlon/Forstmann Little deal.<sup>191</sup>

The Delaware Supreme Court reaffirmed *Unocal*'s requirements<sup>192</sup> but made clear that the *Revlon* situation was different as the company is clearly for sale. Indeed, both bidders would bust up the company and the enterprise would cease to exist under the new ownership and management.<sup>193</sup> Put differently, there is no longer any "corporate policy or effectiveness" for the target board to ensure going forward, or at least there will not be in the near term.<sup>194</sup> In one of the most noteworthy passages of American corporate law, the Delaware Supreme Court articulates what has become known as a target board's *Revlon* duties:

"[...] When Pantry Pride increased its offer to \$50 per share, and then to \$53, it became apparent to all that the break-up of the company was inevitable. The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from a preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standard. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company".<sup>195</sup>

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<sup>191</sup> *Ibid.* at 179.

<sup>192</sup> *Ibid.* ("In adopting the [defensive tactics], the board protected the shareholders from a hostile takeover at a price below the company's intrinsic value, while retaining sufficient flexibility to address any proposal deemed to be in the stockholders' best interest." at 181).

<sup>193</sup> *Ibid.* at 176-80.

<sup>194</sup> Troy, "Control", *supra* note 48 at 141.

<sup>195</sup> *Revlon*, *supra* note 184 at 182.

Put simply, once the target company is clearly for sale, the board has a duty to play auctioneer and to secure the highest price possible for its shareholders. The Delaware Supreme Court concluded that ignoring the duty to the shareholders to maximize the sale price in favor of a deal which protected the directors from liability breaches the board's duty of loyalty.<sup>196</sup> The stakeholder/shareholder debate is therefore solved in these specific circumstances.

The Delaware Supreme Court drew a clear distinction between the earlier defensive measures of the target company's directors – in *Unocal* – and those implemented after the sale or break-up of the company became inevitable – in *Revlon*. It held that the nature of the board's responsibilities fundamentally changes once the company's sale becomes inevitable. Revlon directors could have defeated Pantry Pride's hostile bid anytime before the sale of the company is inevitable; it would have been the same analysis that under *Unocal*, where Mesa's bid threatened Unocal's independence. In this scenario, the Revlon board would have continued to have managerial control over the company. But here, the directors essentially gave up their role in managing the company's business by putting Revlon up for sale. Therefore, a target board's discretion in responding to a hostile takeover is narrower under *Revlon* than *Unocal*.<sup>197</sup> It has been concluded by many that a sale of the company as in *Revlon* is not falling within the scope of the board's authority to manage the corporation; *Unocal* is primarily about board control whereas *Revlon* is primarily about shareholder control.<sup>198</sup> U.S. courts' problem has been to try to define a director's duty during a takeover; *Revlon* tells us the duty is to the shareholders, so

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<sup>196</sup> *Ibid.*

<sup>197</sup> Troy, "Control", *supra* note 48 at 139. See also Blair, "Team Production", *supra* note 35 ("The Revlon exception to the general rule may reflect an intuitive judicial recognition that when a firm 'goes private', it abandons the mediating hierarchy approach in favour of a grand-design principal-agent structure dominated by a controlling shareholder" at 309).

<sup>198</sup> Troy, "Control", *supra* note 48 at 141.

this at least is certain, even if the rest of corporate life is not. In general, agency costs are not such a big concern since they basically do not arise (directors' duty are to the shareholders and the corporation both representing one entity). The court seems to worry about agency costs only in the event that a takeover is inevitable, because at this point they are not ambiguous; the duty of the director is therefore to get the best deal for the shareholders, the interests of shareholders being paramount. Consequently, whether or not *Revlon* is triggered goes a long way in determining the validity of a target board's defensive tactics. "What triggers *Revlon*?" remains a critical question.

#### 2.1.1.3. *Paramount*: The Right to "Just Say No"

The Delaware Supreme Court's *Paramount* decision marks a retreat from a developing line of the Chancery Court precedents calling for more intense judicial scrutiny of defensive tactics and ultimately more shareholder choice in takeovers.<sup>199</sup> Indeed, *Paramount v. Time*<sup>200</sup> leans heavily toward a directors' discretion position, allowing Time to complete a strategic merger with Warner despite a Paramount offer at a substantial premium.

To be more precise, after months of negotiations, a stock-for-stock merger was decided between Time and Warner, according to which Warner shareholders would have owned approximately 62% of the common stock of the combined company.<sup>201</sup> The parties agreed to ensure that Time's directors would control the Time-Warner board and/or fill key senior management positions.<sup>202</sup> Also, Time's board adopted a number of defensive tactics to strengthen the merger.<sup>203</sup> Before the closing date

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<sup>199</sup> Further discussion of this jurisprudential trend will be found in section 2.1.2.2., below.

<sup>200</sup> *Paramount Communications Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989) [*Paramount*].

<sup>201</sup> *Ibid.* at 1143-44 (Time believed that the future media market required integrated firms with international scope).

<sup>202</sup> *Ibid.* at 1144, 1146.

<sup>203</sup> *Ibid.*

however, Paramount made a counter offer, which Time labeled as inadequate, based on the considerable increase the value of the company that the merger between Time and Warner would eventually generate.<sup>204</sup> Moreover, Time's directors were concerned that Paramount posed a threat to the "Time culture" and to the company's editorial integrity.<sup>205</sup> Also, Time's board main apprehension was shareholders' vote that was required to approve the merger; directors were worried that shareholders would not appreciate the long-term benefits of the Warner deal and would instead accept Paramount's bid, which represented a significant premium.<sup>206</sup> Therefore, Time restructured its deal with Warner from a merger to a tender offer by Time for Warner's shares.<sup>207</sup> Eventually, Paramount raised its bid one more time but when the Time board rejected it again, Paramount and Time's shareholders decided to file suit.

There were two related issues in this case.<sup>208</sup> First, the issue regarding whether the Time-Warner deal triggered *Revlon*: if *Revlon* was triggered, then the Time board could probably not have refused to entertain Paramount's bid. Second, if the court assumes that *Revlon* is not triggered, there was still the auxiliary question of whether Time's defensive tactics – the restructuring of its deal with Warner to avoid the Time's shareholders vote – was subject to the *Unocal* test.

The Delaware Supreme Court began by favoring board's control, stating that the directors' broad authority should be respected: "Directors are not obligated to abandon a deliberately conceived corporate plan for short-term shareholder profit unless there

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<sup>204</sup> *Ibid.* at 1151.

<sup>205</sup> *Ibid.* at 1144, 1148.

<sup>206</sup> *Ibid.* at 1148.

<sup>207</sup> *Ibid.* at 1148.

<sup>208</sup> *Ibid.* ("Under what circumstances must a board of directors abandon an in-place plan of corporate development in order to provide its shareholders with the option to elect and realize an immediate control premium? As applied to this case, the question becomes: Did Time's board, having developed a strategic plan of global expansion to be launched through a business combination with Warner, come under a fiduciary duty to jettison its plan and put the corporation's future in the hands of its shareholders?" at 1149).

is clearly no basis to sustain the corporate strategy”.<sup>209</sup> It further identified the two scenarios which require the *Revlon* auctioneer duty: when the board actively initiates a bidding to sell itself, and also where the board abandons the company’s long term strategy in favor of a break-up of the company.<sup>210</sup> The Court held that such Time’s action did not invoke either of these situations because there was no evidence that the proposed merger with Warner represented either “a decision to sell Time or an effort to break-up Time”.<sup>211</sup> Consequently, the directors’ action did not trigger the *Revlon* duties. Then, the court applied the *Unocal* test to Time’s defensive actions taken in response to Paramount’s hostile offer and found that the defensive response was reasonable to the perceived threat and that such action didn’t prevent Paramount from “subsequently bidding on the combined Time-Warner”.<sup>212</sup> According to the Delaware Supreme court, Time’s incumbent management’s self-serving characterization of the all-cash, all-shares tender offer by Paramount as “inadequate” was sufficient justification for denying their shareholders the opportunity to decide for themselves whether or not the offer was adequate.<sup>213</sup>

Had the board determined that the offer is not in the best interests of the corporation and had it not approved sale of control to any other party, the court made clear that, under Delaware law, a board is not required to simply “let the shareholders decide” whether to accept a premium offer. Target shareholders do not have a word to say over a bid that compromises the directors’ authority to manage the company and determine its long-term strategy. Much of the reasoning by the Delaware Supreme Court suggested that almost anything would be considered a legitimate threat

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<sup>209</sup> *Ibid.* at 1154.

<sup>210</sup> *Ibid.* at 1150.

<sup>211</sup> *Ibid.* (“The plaintiffs contended that the original stock-for-stock merger put Time up for sale” at 1149).

<sup>212</sup> *Ibid.* at 1155.

<sup>213</sup> *Ibid.* at 1153.

justifying the use of defensive tactics. The decision allows managers to “just say no” and even “just say never” when they faced a hostile bid and it seems that they can hide forever behind their poison pill defenses.<sup>214</sup> Indeed, this decision tilts the balance strongly toward management discretion and away from shareholder choice: “Fending off a hostile takeover, when done to protect a deliberately conceived corporate plan, is part and parcel of a board’s authority over a corporation’s business and affairs”.<sup>215</sup> The decision ratio is quite extreme when it is positioned into the takeover debate; even fourteen years after it, few have offered a model that can explain the logic of the case.<sup>216</sup> Importantly enough, the decision is also wrapped up with the question of to whom the directors owe a duty, to the shareholders, or to stakeholders (the corporation is arguably a stand-in for the stakeholders). Here, the court is talking a lot about corporate culture, which seems to indicate that the corporation has its own interests that are not necessarily those of the shareholders, and that have to be looked after.

#### 2.1.1.4. *Paramount Communications Inc. v. QVC Network Inc.*: The Exception?

Defensive actions were found to be illegitimate only once by the Delaware Supreme Court and this was in *Paramount Communications Inc. v. QVC Network Inc.*<sup>217</sup> Here, judges set forth that a change of control primarily implicates shareholder control rights and not board control – in contrast with *Paramount I* – thereby triggering *Revlon* and limiting the target board’s authority to helping the shareholders get the best value for their shares.

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<sup>214</sup> Jeffrey N. Gordon, “Corporations, Markets and Courts” (1991) 91 Colum. L. Rev. 1931 at 1932.

<sup>215</sup> Troy, “Control”, *supra* note 48 at 144.

<sup>216</sup> See Michael L. Wachter, “Takeover Defenses when Financial Markets are (Only) Relatively Efficient” (2003) 151 U. Pa. L. Rev. 787 (“The reliance that both sides place on the workings of financial markets, although central to their positions, is left either implicit or is only inadequately developed” at 788). See also Ronald J. Gilson, “Unocal Fifteen Years Later” (2001) 26 Del. J. Corp. L. 491 (asking whether there is an “animating justification” for the current state of Delaware takeover defense jurisprudence, at 492) [Gilson, “Fifteen Years”].

<sup>217</sup> *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994) [*Paramount II*].

After long and heated discussions, Paramount's board unanimously approved a merger whereby Paramount would merge into Viacom.<sup>218</sup> To allow this merger, Paramount amended the company's poison pill, and granted Viacom stock lockups and no-shop promises as well as a termination fee.<sup>219</sup> Shortly after the parties announced their merger plans, QVC made a tender offer bid at \$80 cash for 51% of Paramount's outstanding shares which topped Viacom's offer by more than \$10 per share.<sup>220</sup> However, Paramount's directors refused to alter their preference for Viacom, not only because they believed that QVC's offer was both illusory and too conditional, but also because they were convinced that the Viacom transaction provided better business prospects than the QVC deal.<sup>221</sup> Eventually, QVC filed suit seeking to enjoin the Viacom-Paramount transaction.

In this case, the Delaware Supreme Court ruled that the proposed transfer of control from the public shareholders of Paramount to a controlling shareholder (Viacom) did implicate the *Revlon* duties. First, the court restated that the primary objective for directors when *Revlon* is triggered is "to secure the transaction offering the best value reasonably available to stockholders".<sup>222</sup> It stated that *Revlon* auctioneer requirements are not only necessary when the company initiates a bidding process or when its break-up is inevitable, but also when there is a change in control:

"There are few events that have a more significant impact on the stockholders than a sale of control or a corporate break-up. Each event represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint. It is the significance of each of these events that justifies: (a) focusing on the directors' obligation to seek the best value reasonably

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<sup>218</sup> *Ibid.* at 39.

<sup>219</sup> *Ibid.*

<sup>220</sup> *Ibid.* at 40.

<sup>221</sup> *Ibid.*

<sup>222</sup> *Ibid.* at 43.



available to the stockholders; and (b) requiring a close scrutiny of board action which could be contrary to the stockholders' interests".<sup>223</sup>

The notion of change of control is at the cornerstone of the decision: the board has a duty to protect its shareholders in a change of control because, when a buyout or change of control is inevitable, the shareholders become minority shareholders and lose any meaningful voting influence.<sup>224</sup> Put differently, a transaction resulting in the shareholders of the target becoming minority shareholders of the bidder constitutes a change of control invoking the target board's *Revlon* duties. The target shareholders will not have a second chance at a control premium; after a change-of-control transaction, any future control premium will go to the controlling shareholder: "When a majority of a corporation's voting shares are acquired by a single person or entity, or by a cohesive group acting together, there is a significant diminution in the voting power of those who thereby become minority shareholders".<sup>225</sup> What the court emphasized is the direct relation between the control-premium perspective and shareholder voting rights. Voting control is an asset owned by a corporation's shareholders which become "Mere formalities where there is a majority shareholder".<sup>226</sup> Since shareholders will not have a second chance at a control premium, the target board has a duty to maximize the shareholders' current value, without regard to any long-term business strategy or future corporate policy.<sup>227</sup> Paramount stockholders are therefore entitled to receive a control premium and/or protective devices. For these reasons, the court found that the Paramount board

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<sup>223</sup> *Ibid.* at 47-48.

<sup>224</sup> *Ibid.* at 48-51.

<sup>225</sup> *Ibid.* ("Once control has shifted, the current Paramount stockholders will have no leverage in the future to demand another control premium" at 43).

<sup>226</sup> *Ibid.* at 42.

<sup>227</sup> *Ibid.* ("Irrespective of the present Paramount Board's vision of a long-term strategic alliance with Viacom, the proposed sale of control would provide the new controlling stockholder with the power to alter that vision" at 43).

breached its duty to modify the bid with Viacom and should have negotiated with QVC in order to get the highest price for the shareholders.<sup>228</sup>

Given the similarities of facts between *Paramount I* and II, the reader might be surprised by the two opposing judgments. Again, the notion of change of corporation control is the keystone; in the first case, the Court of Chancery had found that there was no change of control in the originally proposed merger between Time and Warner because both before and after the transaction Time was to be owned by a “fluid aggregation of unaffiliated stockholders”;<sup>229</sup> the Time shareholders would continue to have an effective voice in a combined Time-Warner and would not be subject to the authoritative will of a controlling shareholder, even though they may have suffered dilution. Also, the Time management team would have been in control of the combined company.<sup>230</sup> On the other hand, the *QVC* court found that the transfer of control of Paramount from public shareholders to Viacom did constitute a change of control and thus requires compliance with Revlon.

#### 2.1.2. The Difficulty to Characterize U.S. Takeover Regulation

The extensive powers that are given to the board of directors under Delaware law to make day-to-day business decision are not unlimited.<sup>231</sup> Regarding the takeover decision, U.S. case law seems to parallel this principle-exception rationale, i.e. by giving broad powers to directors, but no absolute ones. Even though the U.S. jurisprudence has features of the managerialist school, what must always be kept in

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<sup>228</sup> *Ibid.* at 47.

<sup>229</sup> *Ibid.* (“Effectuation of the merger would not have subjected Time shareholders to the risks and consequences of holders of minority shares. This is a reflection of the fact that no control passed to anyone in the transaction contemplated. The shareholders of Time would have ‘suffered’ dilution, of course, but they would suffer the same type of dilution upon the public distribution of new stock” at 46).

<sup>230</sup> *Ibid.*

<sup>231</sup> The Delaware General Corporation Law code gives the board of directors a central role in corporate decision making, but it also requires shareholder approval for many fundamental transactions. See *Delaware General Corporation Law* §251 (2001) (regarding mergers) and § 271 (regarding sales of substantially all the assets of the firm).

mind is the ambiguity of U.S. courts towards to shareholder/stakeholder debate. As long as the debate remains unsolved and a shareholder approach is not clearly affirmed, U.S. courts will never be completely managerialist, since a managerialist approach assumes shareholder choice, as it was explained in Chapter 1.

#### 2.1.2.1. The Features of the Managerialist School

In *Unocal*, the Delaware Supreme Court realized how crucial the conflict of interest that may occur in the context of a hostile takeover was. The judicial scrutiny that is imposed – the *Unocal* test – aims at protecting against the possibility that incumbent directors act “solely or primarily out of a desire to perpetuate themselves in office”.<sup>232</sup> However, in practice, there is almost no meaningful judicial review to this test; Robert Thompson and Gordon Smith empirically recognize that the *Unocal* test is no more than an “empty formality”.<sup>233</sup> Concerning the first prong, it seems that the “mere incantation” of a threat is usually enough.<sup>234</sup>

“In cases after *Unocal*, courts have interpreted threats so broadly that almost any threat - no matter how trivial - suffices under the first prong of the analysis. [...] Between the issuance of *Unocal* in 1985 and the end of 2000, the Delaware Court of Chancery issued 141 opinions citing *Unocal* and the Delaware Supreme Court issued 33 opinions citing *Unocal*. [...] Only 34 Court of Chancery opinions and eight Supreme Court opinions work through the entire *Unocal* analysis and reach a conclusion in the case. Very few cases are decided exclusively on the first prong of *Unocal*. In almost every case raising this issue, the courts find a cognizable threat”.<sup>235</sup>

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<sup>232</sup> *Unocal*, *supra* note 165 at 955.

<sup>233</sup> Thompson, “Sacred Space”, *supra* note 135 at 283.

<sup>234</sup> Gilson, “Fifteen Years”, *supra* note 216 at 498.

<sup>235</sup> Thompson, “Sacred Space”, *supra* note 135 at 294.

The second prong – the proportionality review – also lacks substance. Ronald Gilson and Reinier Kraakman asked whether there was a real substance to the proportionality review of defensive tactics. According to the authors, the development of the proportionality test is a regulatory one rather than a threshold, the purpose of which being to diminish the risk of “substantive coercion”, i.e. “The risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management’s representations of intrinsic value”.<sup>236</sup>

At the end of the day, *Unocal* intermediate standard of review is little more than the ordinary business judgment rule.<sup>237</sup> It is important to mention here that the modified business judgment rule has been criticized as favoring the entrenchment of directors, most of the time at the expense of shareholders’ interests. For example, Christian Kirchner and Richard Painter consider this regime to be “tilted against hostile bidders”, whereby only sixteen percent of U.S. mergers and acquisitions transactions in the 1990s that were classified as hostile resulted in the target were being sold to the initial bidder.<sup>238</sup> Also, the transition from *Unocal* mode to *Revlon* mode is controversial. Some scholars had difficulties to define the range of circumstances under which defensive tactics would pass judicial review.<sup>239</sup> It has resulted in a “push-me-pull-you game of scrutinizing directors’ actions”,<sup>240</sup> which some authors consider to have ultimately expanded the scope of directors to adopt defensive measures against hostile takeovers.<sup>241</sup> As a result, the Delaware model leaves more or less directors as the arbiters of the hostile bid.

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<sup>236</sup> Gilson, “Proportionality”, *supra* note 44 at 274.

<sup>237</sup> Kirchner, “European Modified Business Judgement Rule”, *supra* note 11 at 16.

<sup>238</sup> *Ibid.* at 28.

<sup>239</sup> Gilson, “Proportionality”, *supra* note 44 at 256-60.

<sup>240</sup> Ventrone, “Contrasts”, *supra* note 7 at 24.

<sup>241</sup> *Ibid.* at 33.

There are other reasons to believe that the U.S. system is a managerialist one. First, according to some Delaware's Courts, the corporation does not exist solely for the benefit of the shareholders' short-term gains.<sup>242</sup> Therefore, the role of directors is not only important but also needed. Secondly, by excluding from the reach of Revlon stock merger transactions in which the resulting company will not have a controlling stockholder, it is argued that "The Delaware courts gave boards substantial leeway to confer reasonable bidding advantages upon their preferred merger partners, thereby insulating such transactions from easy disruption from topping bids".<sup>243</sup> Finally, by the end of the 1980s, over forty states had enacted anti-takeover legislations that protected the managers of companies incorporated in the state, thus giving target managers new tools for resisting unwanted takeover bids.<sup>244</sup>

#### 2.1.2.2. The Features of the Shareholder Choice School

As a matter of principal, the neutrality rule has always been rejected by Delaware's jurisprudence: "Clearly [it] is not the law of Delaware, and as the proponents of this rule of passivity readily concede, it has not been adopted either by

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<sup>242</sup> See Henry Hansmann & Reinier H. Kraakman, "The End of History for Corporate Law" (2001) 89 Georgetown Law Journal 439. See also E. Norman Veasey, "Should Corporation Law Inform Aspirations for Good Corporate Governance Practices - or Vice Versa?" (2001) 149 U. Pa. L. Rev. 2179.

<sup>243</sup> Allen, "Great Takeover Debate", *supra* note 15 at 1098.

<sup>244</sup> For the leading article on anti-takeover laws, see Roberta Romano, "The Political Economy of Takeover Statutes" (1987) 73 Va. L. Rev. 111. For a quick history of anti-takeover statutes in the U.S., see Ventrone, "Contrasts", *supra* note 7 ("State legislatures have influenced defensive measures through their passage beginning at end of the 1960s of so-called 'anti-takeover statutes. These statutes were specifically designed to help resident or incorporated corporations in fending off hostile attacks. The anti-takeover statutes can be broken down into several 'generations,' based on the mechanisms they employ to protect resident corporations and the nature of challenges to them by foreign bidders whose efforts to acquire an out-of-state corporation" at 28); Lucian Bebchuk & Allen Farrell, "A New Approach to Takeover Law And Regulation Competition" (2001) 87 Va L. Rev. 111 at 129. See also Ira M. Millstein & Salem M. Katsh, *The limits of Corporate Power – Existing Constraints on the Exercise of Corporate Discretion* (New York: MacMillan Publishing Co., Inc., 1981) ("Historically, the Delaware statute minimized restrictions on corporate management; this led to Delaware's becoming the most popular state of incorporation" at 4). For an example of anti-takeover statutes, see Armour, "Rules for Hostile Takeovers", *supra* note 1 ("Under Pennsylvania's anti-takeover law, [...] managers are permitted to take non-shareholder interests into account when they decide whether to resist a bid; bidders lose their voting rights unless the remaining shareholders vote to reinstate the rights; and bidders are subject to 'fair price' provisions if they acquire control of the company" at 10).

courts or state legislatures”.<sup>245</sup> However, two actors seem to push towards the recognition of a shareholder model: the Delaware Court of Chancery on one hand and the financial scandals that rocked the U.S. on the other hand may persuade that the shareholder choice is the new alternative in Delaware takeover law.

*Interco* and *Pillsbury* are the two most remarkable cases acting towards the recognition of the shareholder choice into Delaware law. The *Interco*<sup>246</sup> case is especially notable, as it was the first case that restricted the powers of a board to “just say no”. Here, the Interco board fended off a bid from a corporate raider claiming that the bid was inadequate.<sup>247</sup> To counter this hostile takeover bid, it adopted a restructuring proposal – increased leverage and the sale of some lines of business – in order to duplicate the hostile bidder’s strategy.<sup>248</sup> This plan would have given shareholders the full profits that would otherwise have been shared with the bidder had the hostile offer prevailed.<sup>249</sup> Here, the court of Chancery logically applied the *Unocal* test to the board’s actions and concluded that this poison pill could not be used to prevent indefinitely shareholders from considering a fully financed, all-shares, all-cash tender offer; once a certain period of alternatives had passed, and the “end stage” had been reached, the board had to allow shareholders to make a choice.<sup>250</sup> In other words, the court gave the target directors only a limited period of time to develop alternatives to a non-coercive takeover bid; after this span of time, any defenses shall be removed and shareholders should be able to give the final say. Some authors recognized that “While target management could take time to look for and pursue a more favorable alternative, in the end a court would order the pill redeemed, leaving

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<sup>245</sup> *Unocal*, *supra* note 165 at 955.

<sup>246</sup> *City Capital Assoc. L.P. v. Interco Inc.*, 551 A 2d 787 (Del. Ch. 1988) [*Interco*].

<sup>247</sup> *Ibid.* at 792.

<sup>248</sup> *Ibid.* at 793.

<sup>249</sup> *Ibid.* at 794-95.

<sup>250</sup> *Ibid.* at 798.

the target company's future in the hands of its shareholders".<sup>251</sup> With *Interco* began a shareholder choice trend.<sup>252</sup> The Court of Chancery affirmed in *Pillsbury* that the board could not keep its poison pill provision in place in response to a tender offer, even if the decision not to redeem the pill was in accordance with the board's good faith business judgment.<sup>253</sup> We know now that the Delaware Supreme Court in *Paramount I* found this position inconsistent with the fundamental Delaware law principles and reversed both *Interco* and *Pillsbury*.<sup>254</sup> However, it is important to mention that a shareholder choice position was adopted at a certain point in Delaware law; the influence of Lucian Bebchuk did not remain unheeded.

Moreover, with the Sarbanes-Oxley legislation, which purpose is to enforce more stringent management accountability in response to the well-known financial scandals,<sup>255</sup> some scholars argue that a move towards the shareholder choice model has emerged; it has been noted that every case handled by Delaware courts after Sarbanes-Oxley favored shareholders' power to decide on the fate of the company.<sup>256</sup> The most obvious example lies in the application of the *Blasius* principle in *Liquid Audio*. Back in 1988, the Delaware Court of Chancery held in *Blasius*<sup>257</sup> that a high standard of scrutiny applies – the board has the burden to show a “compelling justification” for its conduct – where board's actions have the primary purpose of

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<sup>251</sup> Ronald J. Gilson & Bernard S. Black, *The Law and Finance of Corporate Acquisition* (Mineola, NY: West Publishing Company, 1995) at 871.

<sup>252</sup> The *Interco* doctrine was applied by the Chancery Court in several decisions. See e.g. *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25 (Del. Ch. 1998); *Carmody v. Toll Bros. Inc.*, 723 A.2d 1180 (Del. Ch. 1998); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227 (Del. Ch. 1988).

<sup>253</sup> *Interco*, *supra* note 246 at 1060.

<sup>254</sup> *Paramount*, *supra* note 200 at 1153.

<sup>255</sup> For a good overview of the financials scandals which led to the Sarbanes-Oxley Act in 2002, see John Armour and Joseph A. McCahery, *After Enron, Improving Corporate Law And Modernising Securities Regulation in Europe And the US* (New York: Hart Publishing, 2006).

<sup>256</sup> Guhan Subramanian, “Bargaining in the Shadow of Takeover Defenses” (2003) 113 Yale L. J. 621 at 682. It ties back to our introductory discussions about agency theory and the shareholder/stakeholder debate whereby courts are now more concerned about shareholders in terms of protecting their investment.

<sup>257</sup> *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

impairing the shareholding franchise.<sup>258</sup> The *Blasius* principle arises from the corporate governance policy rationale that considers shareholders' enfranchisement "as the ideological underpinning upon which the legitimacy of the directors managerial powers rest".<sup>259</sup> Thus, a court can find a violation of boards' duties even where the board acted reasonably and in good faith.<sup>260</sup> This so called "*Blasius* doctrine" was expanded into the *Unocal* realm of corporate control and defenses in the Delaware Supreme Court case *Liquid Audio*.<sup>261</sup> Here, MM Companies ("MM") made an offer to acquire Liquid Audio, but the board entered into a merger agreement with a third party.<sup>262</sup> MM then sought to elect two directors at the next annual meeting in order to gain control of Liquid Audio's board.<sup>263</sup> In response, Liquid Audio's board expanded the size of the board and appointed its own directors to fill the new board positions.<sup>264</sup> The Delaware Supreme Court applied *Blasius* "within an application of the *Unocal* standard of review"<sup>265</sup> stating that "When the *primary purpose* of a board of directors' defensive measure is to interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors, the board must first demonstrate a compelling justification for such action as a condition precedent to any judicial consideration of reasonableness and proportionality".<sup>266</sup>

The court therefore expanded the "compelling justification test" to apply it to the "legitimacy of defensive measures adopted by directors in order to prevent a change

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<sup>258</sup> In this case, the Atlas board expanded the size of board and filled the vacancies in order to prevent Blasius from gaining enough board seats to implement what the Atlas board felt were bad policies. *Ibid.* at 660-662.

<sup>259</sup> *Ibid.* at 659.

<sup>260</sup> Harry G. Hutchison, "Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm" (2005) 36 Loyola University Chicago Law Journal 1111 at 1178-1182.

<sup>261</sup> *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003).

<sup>262</sup> *Ibid.* at 1124.

<sup>263</sup> *Ibid.* at 1125-26.

<sup>264</sup> *Ibid.* at 1124.

<sup>265</sup> *Ibid.* at 1132.

<sup>266</sup> *Ibid.*



of control”.<sup>267</sup> As a result, it made a shareholder choice move and marked the willingness and ability of the courts to ignore the business judgment rule and apply their own judgment. Since the directors did not demonstrate a compelling justification for their action in expanding the board, the court ruled that the board expansion should have been invalidated by the Court of Chancery.<sup>268</sup> Certainly, *Liquid Audio* sends a clear signal that the Delaware courts will rigorously review board action that could affect an election contest: “This trend may lead away from *Unocal*, its business judgment deference, and the policy that absent abuse, management is the more skilled corporate decision maker, and may lead to substantive scrutiny of board defensive actions taken in hostile takeovers”.<sup>269</sup>

In the context of our thesis, it means that features of shareholder choice might be indirectly introduced in Delaware law in the future. However, as we speak, we conclude that Delaware has features of a managerialist policy in that it allows directors to refuse takeover bids – either by defensive measures or the right to “say no” – but it is not always clear why they are allowed to refuse them: are they refusing them because they are not in the best interests of shareholders, or because they are not in the best interest of corporations? We can not really answer this question since U.S. courts have not come out clearly and said whether these two interests are the same or different, except when a takeover becomes inevitable, in which case the interests of the shareholders are more important than the interests of the corporation.

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<sup>267</sup> *Ibid.* at 1131.

<sup>268</sup> *Ibid.* at 1132.

<sup>269</sup> Theobald, “Hostile Takeovers”, *supra* note 62 at 682.

## 2.2. The European Shareholder Choice

The European Takeover Directive (“the directive”) represents a major accomplishment, not only by shaping a unique pan-European takeover regulation, but merely by realizing it despite the political tensions and controversies that it led to before its enactment. On the takeover debate, the directive presents the clearest departure from U.S. takeover practices as it opts for the introduction of a neutrality rule preventing the board of directors from enacting post-bid defensive measures or to frustrate the bid unless shareholders give the board specific authorization to do so. With further examination, we see that the directive does not do more than harmonizing most of national laws that were already enforced and which were based on the British City Code. In this section, we offer to analyze the shareholder choice model that is actually enforced in almost all European countries. Retracing the history of the directive (2.2.1.) remains the best way to a good understanding of the neutrality rule set forth in article 9 of the directive (2.2.2.).

### 2.2.1. A Controversial Directive<sup>270</sup>

One rationale for the managerialist view held by Delaware is found in the U.S. constitutional principal of federalism, which sets fierce competition between States for the enactment of the most directors-friendly corporate laws.<sup>271</sup> On the contrary, the

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<sup>270</sup> For an exhaustive description of the directive history, see Klaus J. Hopt, “Takeover Regulation in Europe - The Battle for the 13th Directive on Takeovers” (2002) 15 Australian Journal of Corporate Law 1.

<sup>271</sup> Lucian Bebchuk and Allen Farrell, in their famous piece of doctrine *A New Approach to Takeover Law And Regulation Competition*, explained that federalism amplifies the voice of corporate managers. They first recognize the trend by which states developed incumbents’ power to impede bids: “While state law has always permitted the use of some defensive tactics, states have increasingly expanded the ease with which, and the generality of the circumstances under which, incumbent management can use such tactics to impede a bid. As the threat to incumbent management from hostile takeovers became greater and greater, states responded by permitting more and more potent defenses” See Lucian Bebchuk & Allen Farrell, “A New Approach to Takeover Law And Regulation Competition” (2001) 87

directive adopts a philosophy based on harmonization in order to put an end to “the U.S. economic and political dominance”.<sup>272</sup> It is not a battling system of laws as in the U.S., but a unified set of core values which the states will use to legislate from. In fact, the European Commission Treaty believes that its main objective – the creation of a common market<sup>273</sup> – would only come with the harmonization of takeover laws.<sup>274</sup>

#### 2.2.1.1. The City Code and its Influences in Europe

Interestingly enough, the British regulatory system regarding takeovers is not a legislative production; takeovers are mostly regulated by the Takeover Panel, a non-statutory authority which writes, administers and enforces a non-statutory body of rules referred to as the City Code on Takeovers and Mergers (“the City Code”).<sup>275</sup> Its

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Va L. Rev. 111 at 118. The authors turn to demonstrate that there would be an “implied contract” between directors and States which benefit both of them. On the one hand, states seek to maximize the number of corporations which charter and reincorporate within its borders. On the other hand, since managers want to keep their jobs and benefits, they will ensure by choosing a state that provides better barriers to hostile takeovers. The federalism effect on corporate law creates a “race to the bottom”, i.e. state lawmakers cater to managers, and thus have powerful incentives to favor managers at the expense of shareholders. States enact directors friendly laws because they worry very much that executives “pack the company’s bags and move elsewhere if the state is insufficiently attentive to the managers’ needs” and therefore would have powerful incentives to keep corporate managers happy” See Armour, “Rules for Hostile Takeovers”, *supra* note 1 at 47. This position remains however really controversial in practice. The Delaware state, which roughly sixty per cent of the largest corporations, has a monopoly share of the market. Consequently, according to Lucian Bebchuk’s view, Delaware law would be likely to be more director friendly than other states. However, Delaware was one of the last states to enact an anti-takeover statute, for instance, and its statute gives managers far less discretion than those rushed into the code books by other state legislatures. See Roberta Romano, “Competition for Corporate Charters and the Lesson of Takeover Statutes” (1993) 61 Ford. L. Rev. 843.

<sup>272</sup> Ventrone, “Contrasts”, *supra* note 7 at 2.

<sup>273</sup> The Treaty of Rome established as a goal a common market through among other means, harmonization of corporate law across the European Community. See Forstinger, “Takeover Law”, *supra* note 161 at 25-30.

<sup>274</sup> Bastiaan Van Apeldoorn & Laura Horn, “The European Marketisation Project and the Struggle over the Takeover Directive” (Paper presented at the annual meeting of the International Studies Association, Hilton Hawaiian Village, Honolulu, Hawaii, 05 March 2005), online: <[http://www.allacademic.com/meta/p70607\\_index.html](http://www.allacademic.com/meta/p70607_index.html)>.

<sup>275</sup> For more information on how the Takeover Panel works, see Armour, “Rules for Hostile Takeovers”, *supra* note 1 (“Takeover Panel oversight differs from the US framework for regulating takeovers in at least three important respects. First, the Takeover Panel addresses takeover issues in real time, imposing little or no delay on the takeover effort. In the context of an active bid, the Panel’s Executive requires participants to give it regular updates on compliance. Faced with a protest by one of the parties, it will issue rulings as appropriate. It might, for example, require that a target board remove its interference with a bid, or instruct the bidder to provide additional disclosure, or, decline to take any action at all. To be sure, the Delaware courts provide an extraordinarily prompt response to takeover challenges, often deciding the case as soon as the parties have completed their oral arguments. But the

mission is to ensure that “Shareholders are treated fairly and are not denied an opportunity to decide on the merits of a takeover and that shareholders of the same class are afforded equivalent treatment by an offeror”.<sup>276</sup> It is well established in scholars’ circles that, in contrast to the U.S., takeover regulation in the U.K. has a strikingly shareholder-oriented cast when it comes to takeovers.<sup>277</sup> Indeed, the U.K. takeover regime is an example of a regime that has taken an early and clear position on the use of takeover defenses whereby directors have not been permitted to take any frustrating action without shareholder consent. This sweeping prohibition is obtained in Principle 7 of the Code:

“At no time after a bona fide offer has been communicated to the board of the offeree company, or after the board of the offeree company has reason to believe that a bona fide offer might be imminent, may any action be taken by the board of the offeree company in relation to the affairs of the company, without the approval of the shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits”.<sup>278</sup>

Therefore, shareholders of British companies have the power to decide whether a tender offer is in their interests or not. Poison pills are accordingly strictly forbidden, as well as any other defense that will have the effect of impeding target shareholders’ ability to decide on the merits of a takeover offer, such as buying or selling stock to interfere with a bid, or agreeing to a lock-up provision with a favored bidder.<sup>279</sup> The

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overall process usually takes weeks and sometimes months. The informality of the Takeover Panel, by contrast, enables it to respond almost immediately. ‘The reputation of the Panel in the City depends considerably,’ in the words of one historian, ‘on the efficiency of the Panel executive in dealing promptly, fairly and decisively with the large number of queries that pour into the office every day. If the point is a difficult one, the Panel executive may ask for time to consider, but this is thought of in terms of hours rather than days’” at 21).

<sup>276</sup> See Takeover Panel’s website, online: < <http://www.thetakeoverpanel.org.uk/new/>>.

<sup>277</sup> Armour, “Rules for Hostile Takeovers”, *supra* note 1 at 4.

<sup>278</sup> City Code on Takeovers and Mergers, Principle 7, in Marc Weinberg & Steven Blank, *Weinberg & Blank on Takeovers and Mergers* 5<sup>th</sup> ed. (London: Sweet & Maxwell, 1989) [*City Code*].

<sup>279</sup> Armour, “Rules for Hostile Takeovers”, *supra* note 1 at 10.

pressure to tender problem that could possibly result from the neutrality rule has not been ignored; the City Code addresses it by providing for a second opportunity for shareholders to tender their shares.<sup>280</sup>

As a result, the City Code has always been understood as seriously limiting the ability of target management to block hostile bids, as the shareholder choice school advocates. The City Code bets on “Providing information to the shareholders [...], appealing to shareholder loyalty or patriotism, using their own and their supporters’ resources to buy target company shares in the market [...]”<sup>281</sup> to compensate the drawbacks of the shareholder choice. It is obvious that the enforcement of the principle of board neutrality in the U.K. was not influenced by Frank Easterbrook and Daniel Fischel’s arguments since such a rule was enacted earlier, i.e. in 1968. Surprisingly enough, this principle has always remained uncontroversial in practice. Allen Ferrell explains this absence of debate by the early establishment of the principle, at a time where hostile takeovers were not considered a major threat by corporate managers:

“Hostile takeovers first arrived on the scene in the 1950s. By the end of the 1950s, there was already a preliminary regulatory framework in place. By 1968 the City Code was firmly in place. Taking a sound position early on had two possible benefits. First, corporate managers did not see hostile takeovers as much of a threat as they later on might have given their frequency at the time. This provided regulators with some space, in contrast to the situation in the United States, in crafting a regulatory regime. Secondly, once a regulatory position was adopted a certain degree of inertia

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<sup>280</sup> *Ibid.* However, Lucian Bebchuk admitted that it is not a perfect solution. See Bebchuk, “Toward Undistorted Choice”, *supra* note 122 at 1797-98.

<sup>281</sup> Paul L. Davies, “The Regulation of Defensive Tactics in the United Kingdom and the United States, in European Takeovers” in Klaus J. Hopt & Eddy Wymeersch, eds., *European Takeovers: Law and Practice* (London: Butterworths, 1992) at 200.

inevitably set in. It is harder to change a regulation, generally speaking, than it is to enact one".<sup>282</sup>

Also, John Armour and David Skeel emphasized that the U.K. pays less attention to takeover defenses than the U.S.<sup>283</sup> There are specific aspects of U.K. corporate governance that limit directors' aptitude to entrench themselves *per se*. For example, English company law requires directors to seek approval from the general meeting for authority to issue new shares,<sup>284</sup> and in listed companies this will usually only be granted subject to guidelines formalized by institutional investors.<sup>285</sup>

Many continental European jurisdictions used the British City Code as a benchmark.<sup>286</sup> In fact, it makes more sense to adopt a shareholder choice rule in continental Europe, since corporate ownership is traditionally more concentrated;<sup>287</sup> therefore, the conflict takes place between controlling and majority shareholders, instead of between directors and shareholders as in the U.S. Putting control of the defensive tactics in the hands of directors in many corporations in Europe would be pointless since the corporation is managed by a major shareholder who potentially own a majority of the stock and can thus play with the bidder(s) and use defensive

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<sup>282</sup> Allen Ferrell, "Why Continental European Takeover Law Matters", online: (2003) SSRN: <<http://ssrn.com/abstract=500125>>.

<sup>283</sup> It has also been argued that the contrast on the role of centralized management is another important reason for the difference in takeover regulation. See Davies and Hopt, "Control Transactions" in Reinier H. Kraakman, *The Anatomy of Corporate Law, A Comparative and Functional Approach* (Oxford: Oxford University Press, 2004) ("The contrast between the two systems reflects a more general contrast on the role of centralized management. English law has always seen the powers of the board as flowing from a delegation from the shareholders who consequently control, through the company's constitution, the extent of that delegation. U.S. law has taken a more prescriptive approach to centralized management, with the powers of the board flowing, in part at least, directly from the statute rather than from delegation by the shareholders. In the area of control transactions, the difference seems not to be just a doctrinal one but to be just a doctrinal one but to have significant consequences in practice" at 157).

<sup>284</sup> Armour, "Rules for Hostile Takeovers", *supra* note 1 at 11.

<sup>285</sup> *Ibid.*

<sup>286</sup> Marc Goergen, Marina Martynova & Luc Renneboog, "Corporate Governance Convergence: Evidence from Takeover Regulation Reforms", online: (2005) SSRN: <<http://ssrn.com/abstract=709023>> [Goergen, "Corporate Governance"]. See also Ventrone, "Contrasts", *supra* note 7 at 71.

<sup>287</sup> For a good summary of ownership patterns in Europe and in the U.S., see Henry Hansmann & Reinier H. Kraakman, "The End of History for Corporate Law" (2001) 89 Georgetown Law Journal 439.

tactics as he/she pleases. As a result, there has been a clear move in the recent years towards the adoption of the Code model in Europe, as Figure 1 highlights.

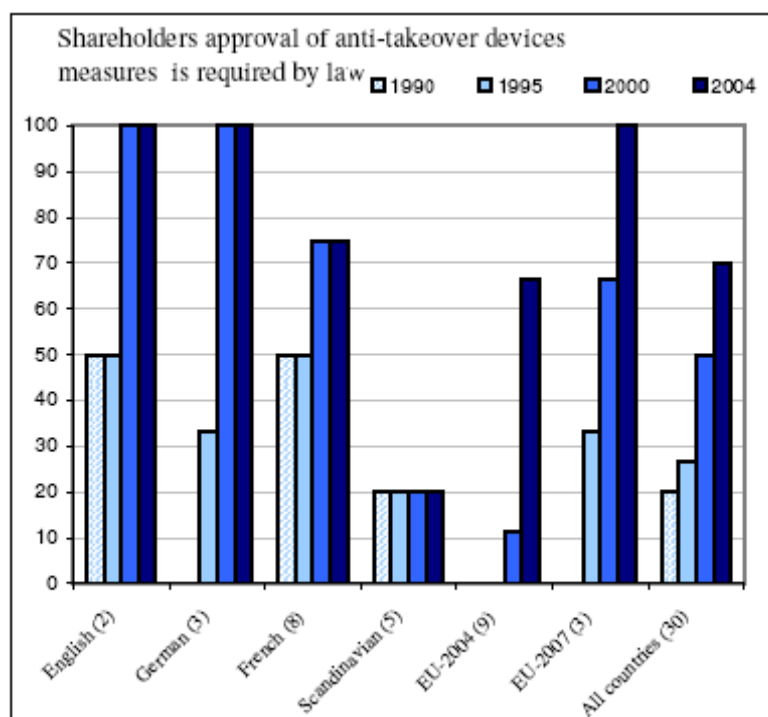


Figure 1: Shareholder Approval of Anti-takeover Devices Measures Required by

Law<sup>288</sup>

Even before the adoption of the directive, national takeover laws already adopted a rule which mirrors the City Code. The harmonization of European takeover regulation logically led to the presence of a neutrality rule in the directive.

#### 2.2.1.2. The Early Discussions and the Rejection of the 12<sup>th</sup> Directive

It took almost thirty years of debate to enact and finally get the directive approved. A common starting point is usually the Pennington Report to the European

<sup>288</sup> Georgen, "Corporate Governance", *supra* note 286 at 28.

Commission which was submitted in 1974,<sup>289</sup> but the real push towards cross-borders takeover regulations began in 1985 with the publication of the White Paper on the Internal Market emphasizing the need for cross-border collaboration as a way of achieving the goal of a common market.<sup>290</sup> At this time already, the European Commission was trying to establish a global level-playing field for a takeover market, the underlying objective of it being to release companies into the market of corporate control “with the expectation that the free market will discipline management and lead to optimal performance and economic growth”.<sup>291</sup> The call for intensifying the efforts to reach a common position and adopt a harmonized regulatory framework was lately prompted by the international acquisition environment.<sup>292</sup> Thus, while the takeover market was steadily increasing, there was an internal European financial market but no harmonization of the law, resulting, among other things, in costs of higher expenditure on consultancy.

In June 2000, a common position – known as the 12<sup>th</sup> directive – for a harmonized regulation that might create a level-playing field was about to be reached. Throughout the discussions, the most controversial point has always been the duty of the board of the target company to remain neutral.<sup>293</sup> Germany withdrew its approval at the last minute fearing that the directorial neutrality rule may lead to increased takeovers.

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<sup>289</sup> Klaus J. Hopt & Eddy Wymeersch. *European Takeovers: Law and Practice* (London: Butterworths, 1992) at 190.

<sup>290</sup> Forstinger, “Takeover Law”, *supra* note 161 at 100.

<sup>291</sup> André Nilsen, “The EU Takeover Directive and the Competitiveness of the European Industry”, online: (2004) The Oxford Council on Good Governance: <http://www.oxfordgovernance.org/fileadmin/Publications/EY001.pdf> at 5.

<sup>292</sup> Georgen, “Corporate Governance”, *supra* note 286. Also, the European Court of Justice rendered a remarkable decision in 2002 in which it held that Portugal and France had violated the European Community Treaty regarding the system of golden shares. The European Court held that the free movement of capital may be restricted only by national rules that fulfill the twofold criterion of being founded on overriding requirements of the general interest and being proportionate to the objective pursued. See *Commission of the European Community v. Portugal*; *Commission of the European Communities v. French Republic*; *Commission v. Belgium*, cases C-367/98, C-483/99 and C-503/99, [2002] E.C.R. II-01169.

<sup>293</sup> Peter O. Mülbert & Max Birke, “In Defense of Passivity - on the Proper Role of a Target's Management in Response to a Hostile Tender Offer” (2000) 1 *European Business Organization Law Review* 445.



Representatives of German companies had praised for modifications of the proposed directive directly to the German Chancellor Gerhard Schroeder in April 2001.<sup>294</sup> Then, Germany's deputy representatives to the European Union notified the European Commission that their country would no longer back the directive unless the neutrality rule was erased.<sup>295</sup> At the end of the day, the 12<sup>th</sup> directive was rejected by a tied 273-273 vote in the Parliament. Its rejection was suffered as a "Tragic [...] and a major set-back to the goal of reaching an integrated capital market",<sup>296</sup> especially since the European Commission believed it was the keystone to make Europe the leading world economy.<sup>297</sup> A few months later, against all expectations, Germany enacted laws – especially Section 33 of the German Securities and Acquisitions Act – that grant boards of directors the powers they needed to defend against hostile takeovers.<sup>298</sup>

#### 2.2.1.3. The Winter Group: the Acceptation of the Shareholder Choice Model in European Corporate Law

Overall, the rejection of the 12<sup>th</sup> directive made the European Commission very disappointed since it was based on the U.K. City Code provisions, which many member states were already enforcing versions of.<sup>299</sup> This blow made some scholars believed that the directive will fail to be eventually implemented.<sup>300</sup> However, the leveled-playing field was too important to be left aside, and Commissioners persisted to harmonize European takeover regulation. They set up a High Level Group of

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<sup>294</sup> Rolf Skog, "The Takeover Directive - An Endless Saga?" (2002) 13 European Business Organization Law Review 301.

<sup>295</sup> *Ibid.* at 314.

<sup>296</sup> EU Takeover Code Thrown Out, quoting European Commissioner Frits Bolkestein, *BBC News* (July 4, 2001) online: BBC News < <http://news.bbc.co.uk/1/hi/business/1422107.stm>>.

<sup>297</sup> Forstinger, "Takeover Law", *supra* note 161 at 101.

<sup>298</sup> Further discussion of Section 33 of the German Securities and Acquisitions Act will be found in section 3.5., below.

<sup>299</sup> Erik Berglöf & Mike Burkart, "European Takeover Regulation", online: (2003) SSRN <<http://ssrn.com/abstract=405660>> at 189-190.

<sup>300</sup> This is, in essence, what Ernesto Hernández-López thinks. See Ernesto Hernández-López "Bag Wars and Bank Wars, The Gucci and Banque National De Paris Hostile Bids: European Corporate Culture Responds to Active Shareholders" (2003) 9 Fordham J. Corp. & Fin. L. 127.

Company Law Experts, often referred to as the Winter Group, which mission was first to provide independent advice on issues related to European rules for takeover bids, and second to “[...] deliver a preliminary report on its recommendations concerning rules for takeover bids by the end of 2001 [...]”.<sup>301</sup> This final report was delivered on time, and, in accordance with the previous Commission’s positions, the Winter Group reminds that an important goal of the European Union was to create an integrated capital market by 2005 of which a politically viable and effective takeover regulation of takeover bids was the key element.<sup>302</sup> On the face of it, the Winter Group affirmed that the creation of a level playing field for takeover bids should be guided by a shareholder decision-making:

“In the event of a takeover bid the ultimate decision must be with the shareholders. They should always be able to decide whether to tender their shares to a bidder and for what price. It is not for the board of a company to decide whether a takeover bid for the shares in the company should be successful or not. This is not to say that the board has no responsibility at all in the context of a takeover bid. It is sometimes argued that allowing the board to frustrate a takeover bid can be justified as a means to help take into consideration the interests of shareholders and other stakeholders in the company, notably the employees. The Group rejects these views. Defensive mechanisms are often costly. Most importantly, managers are faced with a significant conflict of interests. Shareholders should be able to decide for themselves and stakeholders should be protected by specific rules (e.g. on labor law or environmental law)”.<sup>303</sup>

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<sup>301</sup> Report of the High Level Group of Company Law Experts On Issues Related to Takeover Bids, online: European Commission Website (2002): <[http://ec.europa.eu/internal\\_market/company/docs/takeoverbids/2002-01-hlg-report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/takeoverbids/2002-01-hlg-report_en.pdf)> at 1 [Report]

<sup>302</sup> *Ibid.* at 18.

<sup>303</sup> *Ibid.* at 2.

It is obvious that, with regards to the stakeholder/shareholder debate, the group advocated a shareholder model of the corporation where directors are meant to act in the interest of shareholders only. Since it proposed to turn shareholder into those who decide the fate of a company, it is conceivable that this approach garnered support among the Jacksonians who advocate the inefficiency of defensive measures.<sup>304</sup> Moreover, their rationale is quite comparable to the one adopted by the shareholder choice school, as the report conceives takeovers as disciplinary tools:

“In the light of available economic evidence the Group holds the view that the availability of a mechanism for takeover bids is basically beneficial. Takeovers are a means to create wealth by exploiting synergies and to discipline the management of listed companies with dispersed ownership, which in the long term is in the best interests of all stakeholders, and society at large. These views also form the basis for the Directive”.<sup>305</sup>

With these assumptions in mind, it is no surprise that they recommended that after announcement of the bid, the board of the target should not be permitted to take any action that frustrates a bid unless the general assembly authorizes these defensive actions. In short, the Group reasoned as follows: since the conflict of interest is insolvable, let's not have it at the first place.<sup>306</sup>

#### 2.2.2. The Neutrality rule in the Directive

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<sup>304</sup> Thompson, “Sacred Space”, *supra* note 135 (“U.S. style failed since “judicial scrutiny as the primary shareholder protection against director action taken in a takeover setting has not worked as it was intended, primarily because of the difficulty of a third-party judge separating director actions that may have an entrenchment motive from those that could benefit the shareholders. The result is that defensive tactics are almost never overturned by a court. A better alternative--based on insights from the theory of the firm is to permit direct shareholder action to vote and to sell, and to enact antidotes to director actions that frustrate such shareholder action within the space provided for them by corporate law” at 321.)

<sup>305</sup> See *Report*, *supra* note 301 at 18-19

<sup>306</sup> See *Ibid.* at 21.

As the commission clearly did not want to reopen general discussions on the takeover regulation, a new final draft was presented in late 2002 and focused on the introduction of five provisions: a mandatory bid rule, the principle of equal treatment of shareholders, a squeeze-out rule or sell-out right, the principle of board neutrality and a break-through rule. Its adoption was conditioned to an opt-out rule, in which member states would retain the freedom to opt-out of the requirement of the neutrality. For matters of consistency, this very rule will be analyzed in Chapter 3.

#### 2.2.2.1. Article 9 of the Directive: The European Neutrality Rule

To be clear, the obligations of the board of the target company are stated at paragraph 2 and 3 of article 9 of the directive:

“2. [...] the board of the offeree company shall obtain the prior authorisation of the general meeting of shareholders given for this purpose before taking any action, other than seeking alternative bids, which may result in the frustration of the bid and in particular before issuing any shares which may result in a lasting impediment to the offeror's acquiring control of the offeree company.

Such authorisation shall be mandatory at least from the time the board of the offeree company receives the information referred to in the first sentence of Article 6(1) concerning the bid and until the result of the bid is made public or the bid lapses. Member States may require that such authorisation be obtained at an earlier stage, for example as soon as the board of the offeree company becomes aware that the bid is imminent.

3. As regards decisions taken before the beginning of the period referred to in the second subparagraph of paragraph 2 and not yet partly or fully implemented, the general meeting of shareholders shall approve or confirm any decision which does not form part of the normal course of the company's business and the

implementation of which may result in the frustration of the bid.”<sup>307</sup>

The board of directors must obtain shareholders’ approval to take action – other than seeking alternative bids which may result in the frustration of the bid – and in particular before issuing any shares which may result in a lasting impediment to the buyer in obtaining control. Accordingly, poison pills are *a priori* forbidden. Contrary to the new German law allowing the 18 months renewable authorization given prior to any impending takeover effort,<sup>308</sup> article 9 of the directive requires specific shareholders’ authorization given during the relevant time period in order for the board to act.<sup>309</sup> The language of §3 makes this intention of informed authorization very clear: “Decisions made before the beginning of an offer, which are not yet fully implemented when an offer is made, require shareholder approval to continue if they have ability to upset the bid attempt and are not otherwise part of the normal course of company business”.<sup>310</sup>

#### 2.2.2.2.The Remaining Roles of Directors

Given that the general shareholders’ meeting is the only corporate body that is competent to authorize measures on whether to counter the bid or not, the reader might be wondering what the remaining functions of directors of European companies are.

First, the board of the target company will be able to seek a competing bid – commonly referred to as a “white knight” – without an authorization by the general meeting, even though the competing bid may in practice frustrate the first takeover

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<sup>307</sup> Directive, art. 9, *supra* note 14.

<sup>308</sup> Further discussion of Section 33 of the German Securities and Acquisitions Act will be found in section 3.5., below.

<sup>309</sup> Ventrone, “Contrasts”, *supra* note 7 at 61.

<sup>310</sup> Theobald, “Hostile Takeovers”, *supra* note 62 at 47.

bid.<sup>311</sup> There is a debatable question in takeover law on either directors should be able to look for a white knight. According to many legal scholars, this exception is “fair and reasonable” because the board will be acting in the interest of the shareholders; therefore it is useless to ask the general meeting for a prior authorization.<sup>312</sup> In searching for competing bids, boards enhance shareholders wealth, which is consistent with their representatives’ duties. Other scholars argued that the competitive bid should be considered as a mere alternative for shareholders: seeking a white knight does not need being authorized by the general meeting, only because competing bids are not truly obstacles for the first bid: “A competing bid embodies only a second choice for the shareholders, which does not alter the market, and therefore could not be considered as a defensive measure at all”.<sup>313</sup> Lucian A. Bebchuk exposed a good study of the white knight debate in *The Case for Facilitating Competing Tender Offers*,<sup>314</sup> as a response to Frank Easterbrook and Daniel Fischel’s strict passivity rule. He argued that allowing the search for a white knight benefit targets’ shareholders: first, it increases the probability that they will receive a premium. Second, strengthening the takeover threat may induce present managements to be more profit maximizing.<sup>315</sup> The more that prospective buyers search, the greater is the likelihood that a potential takeover target will be identified.

Second, directors are responsible for secondary tasks. Advising shareholders on the issue at stake, perhaps convincing them is the best they are allowed to do. They “shall draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of

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<sup>311</sup> Directive, art. 9 §5, *supra* note 14.

<sup>312</sup> Francesco Vello, “La Nuova Passivity Rule Nella Disciplina Delle Offerte Pubbliche d’Acquisto: Alla Ricerca Di Un Difficile Equilibrio” (2000) Banca Impresa Società 176.

<sup>313</sup> Federico M. Mucciarelli, “White Knight and Black Knight”, online: (2007) De Gruyter: <<http://www.atypon-link.com/WDG/doi/abs/10.1515/ECFR.2006.018?journalCode=ecfr>>.

<sup>314</sup> Bebchuk, “Facilitating Competing Tender Offers”, *supra* note 91.

<sup>315</sup> *Ibid.* at 1034.

the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business [...]"<sup>316</sup>

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<sup>316</sup> *Directive*, art. 9 §5, *supra* note 14.

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After this complete study of the role of directors in both systems, we conclude that the content of takeover regulation differs just as markedly on the two sides of the Atlantic. Delaware takeover law has long been criticized for lacking a coherent theory to justify its apparent reliance on boards' discretion as a rule to address the takeover debate. As we explained previously, the U.S. has not clearly come down on one side or the other of the shareholder/stakeholder debate, except in *Revlon*-like cases in which a shareholder model is enforced and the approach is the shareholder choice. On the contrary, the European Union is strongly weighted towards protecting the interests of shareholders. Unless shareholders consent, the directive strictly prohibits directors from employing any defensive tactics that would have the effect of frustrating actual or anticipated bid. An exception, and not one to be taken lightly, is the search of a white knight which indeed effectively gives directors the power to frustrate a hostile bid. Therefore, there is no strict application of the shareholder choice model in Europe. What we conclude is simple yet important. The two schools of thought do not fully find their place in Europe and in the U.S. systems.

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## Chapter 3

### 3. Six Reasons Why the U.S. Managerialist Model Prevails

On the face of it, it is very difficult to compare the two regulatory approaches and find the one that is the most effective and competitive with respect to shareholders' interests. First, the economic theory gives no clear indication as to the right takeover law.<sup>317</sup> Second, we can not justify the Jacksonians' model solely on the ground that it addresses the agency problems between boards and shareholders of target companies.<sup>318</sup> Also, blindly granting directors with takeover defenses appears to provide considerable scope for managerial entrenchment which could possibly exacerbate the very agency costs. There are, as a matter of fact, doubts in the U.S. on whether the decision frustrating the hostile bid can really be left to the free discretion of the board of the target company.<sup>319</sup> However, the power to erect defensive measures and/or veto may also protect the shareholders of the target against opportunistic conduct on the part of the acquirer.

We are convinced that, in order to prove the limits of the shareholder choice model, there is a strong need to find and explore new arguments – different than those

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<sup>317</sup> See Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991) ("Neither independent directors nor a shareholder vote necessarily ensures that a particular transaction will increase shareholders' wealth. Independent directors may be too uninformed to make intelligent decisions. Or maybe friendship in conjunction with directors' fees and a belief that the market won't notice 'just this one time' lead them to play dead. Similarly, collective action problem may cause rational shareholders to vote in favour of a particular transaction even if it is wealth-enhancing" at 104). See also Roberta Romano, "A Guide to Takeovers: Theory, Evidence and Regulation" in Guido Ferrarini, Klaus J. Hopt & Eddy Wymeersch eds., *Capital Markets in the Age of the Euro: Cross-Border Transactions, Listed Companies and Regulation* (Kluwer Law International, 2002) at 403.

<sup>318</sup> See John C. Coates, "The Contestability of Corporate Control: A Critique of the Scientific Evidence on Takeover Defenses", online: (1999) SSRN: <<http://ssrn.com/abstract=173628>>.

<sup>319</sup> In addition to what has been developed in Chapter 1, some American authors have proposed reforms to enforce a shareholder choice in the U.S. In 1983, Professor Louis Lowenstein proposed for the United States a rule similar to the draft Thirteenth Directive. See Louis Lowenstein, "Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation" (1983) 83 Colum. L. Rev. 249 at 255.

developed in Chapter 1 – highlighting all the benefits shareholders can get from a managerialist view. In this chapter, we provide empirical, economic and financial evidences to support that shareholders are better off leaving the takeover decision to the board of directors, regardless of the risks of conflict of interests and the agency costs that are implied. We do not argue against agency costs, or against shareholder primacy; we argue instead for a managerialist position, whereby benefits to the shareholders of leaving the decision to the directors are greater than whatever agency costs exist. Economically speaking, we show that the directive – the shareholder choice model – fails to consider that defensive measures generally increase the price paid for a target company, and therefore the returns to shareholders (3.1). Then, we propose to oppose a recurrent shareholder choice argument by which institutional investors would justify a neutrality rule; we show that the active engagement of these new shareholders does not necessarily substitute for the discipline imposed on directors from the threat of a hostile takeover (3.2). In addition, the initial public offering practice, which is supposed to serve existing and new shareholders in theory, keeps directors’ defensive measures and/or veto power in practice, marking how appreciative of the current Delaware system shareholders are (3.3). Also, we show that, had a shareholder choice been enforced, directors could simply entrench themselves further by employing pre-bid defenses embedded in companies’ contractual arrangements, which would eventually work against shareholders’ own interests (3.4). Our hypothesis has to be verified in the real world as well; at a cross-Atlantic scale, we illustrate the inadequacy of the passivity rule, which may increase political pressure on member states to pass barriers to hostile takeovers. This vicious circle is also highlighted by the opt-out rule which might lead to an unequal level-playing field for hostile takeover activity between the U.S. and Europe whereby

shareholders of European companies might suffer from lower premiums (3.5). Last but not least, Germany provides the best example supporting the superiority of the managerialist view; a Delaware model is currently enforced – after years under the neutrality rule – despite concentrated ownership patterns (3.6).

### **3.1. The Profitability of Auctioneering and Board Veto**

Empirical studies usually find either a negative or a very small return when it comes to bidder shareholders.<sup>320</sup> However, that target shareholders experience significant positive returns from a takeover is constantly brought out, a result that is shared in the United States, in the United Kingdom, and in Europe.<sup>321</sup> An early survey by Michael Jensen and Richard Ruback reported average returns to U.S. targets of thirty percent for tender offers, and forty five percent in case of hostile takeovers.<sup>322</sup> The question now turns out to be whether or not these premiums are higher under the U.S. model. Such a hypothesis would therefore evidence that the managerialist approach is more wealth enhancing for target shareholders than the European model. As a matter of fact, the discretion given to directors of U.S. companies allows them to eventually extract a higher price from initial bidders than in Europe, both from auctioneering and defensive measures.

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<sup>320</sup> See e.g. V.A. Kennedy & R.J. Limmack, “Takeover Activity, CEO Turnover and the Market for Corporate Control” (1996) 23(2) *Journal of Business Finance and Accounting* 267.

<sup>321</sup> For a study regarding shareholders of U.K. companies, see Julian R. Franks & Robert S. Harris, “Shareholder Wealth Effects of Corporate Takeovers: The U.K. Experience 1955-1985” (1989) 23 *Journal of Financial Economics* 225 (positive return of 25.8 on average between 1955 and 1985, at 232); For shareholders of European companies, see Marc Goergen & Luc Renneboog, “Shareholder Wealth Effects of European Domestic and Cross-Border Takeover Bids” (2004) 10 *European Financial Management* 9 (positive return of 29.3% on average between 1993 and 2000, at 23).

<sup>322</sup> Michael C. Jensen & Richard S. Ruback, “The Market for Corporate Control. The Scientific Evidence” (1983) 11 *Journal of Financial Economics* 5. On the substantiality of takeovers premiums, see Bernard Black & Joseph Grundfest, “Shareholder Gains from Takeovers and Restructurings Between 1981 and 1986: \$162 Billion is a lot of Money” (1988) 1 *Journal of Applied Corporate Finance* 5 (“Back in 1789 Benjamin Franklin claimed that nothing was certain in life but death and taxes. If Franklin were alive and paying taxes today he might add a third immutable constant to his list: shareholders gain from takeovers” at 5).

Regarding auctioneering, because target shareholders are dispersed and therefore effective coordination for bargaining is almost impossible, management is the only corporate actor that can “Act as a single and effective bargaining agent on behalf of the shareholders”.<sup>323</sup> In other words, competition among potential buyers may only occur if directors control the bidding process, the outgrowth of such competition being to generally raise the price a seller will receive. Lucian Bebchuk recognized that “Only a competing offer, or the threat of such an offer, will enable the dispersed target’s shareholders to get a substantial share of those gains”.<sup>324</sup> Auction procedures are revenue-maximizing for target shareholders because bidder may often overpay due to auction hubris or “deal fever”. Resolving a competitive takeover situation by an auction will also be an effective mechanism to ensure that the target board is respecting its fiduciary duty towards the shareholders by choosing the highest bidder. Indeed, directors that have a minor stake are prone to reject valuable offers in order to keep their jobs. In *Interco*, the judge clearly affirmed that “An active negotiator with power, in effect, to refuse the proposal may be able to extract a higher or otherwise more valuable proposal”.<sup>325</sup> The profitability of auctioneering being evidenced now, it is no surprise that, even in “shareholder choice countries”, institutions started to conduct auctions, the most notable example being the British Takeover Panel. Indeed, article 32.5 of the City Code states that: “If a competitive situation continues to exist in the later stages of the offer period, the Panel will normally require revised offers to be published in accordance with an auction procedure, the terms of which will be determined by the Panel”.<sup>326</sup> The winner of an auction set up by the Panel is simply recommended to the target board; it does not automatically acquire the target company

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<sup>323</sup> Bebchuk, “The Case Against Board Veto in Corporate Takeovers”, *supra* note 32 at 1007.

<sup>324</sup> Bebchuk, “Facilitating Competing Tender Offers”, *supra* note 91 at 1039.

<sup>325</sup> *Interco*, *supra* note 246 at 798.

<sup>326</sup> City Code art. 32.5, *supra* note 278.

who is free to follow the Panel's recommendation or not. However, practice shows that shareholders generally trust the recommendation.<sup>327</sup> Given the authoritative status of the Panel, one might argue that the target board is likely to adopt the Panel's recommendation which will then, indirectly lead to the shareholders' approval of the auction's winner. Therefore, the profitability of auctioneering is paradoxically recognized in U.K., a country that opted for a strong shareholder choice.<sup>328</sup>

Regarding defensive measures, there are conflicting views as to whether the power of board veto is an effective tool to provoke higher bid prices. Shareholder choice proponents consider that the board veto damages the economic interests of shareholders<sup>329</sup> and also reduces the likelihood of bids occurring in the first place.<sup>330</sup> But they also recognized that defensive tactics lead to a higher takeover price.<sup>331</sup> Indeed, several very serious economic and financial studies show that board veto has a substantial positive effect on premiums: there is an association between poison pills and higher premium in acquisitions,<sup>332</sup> such association being extended to anti-takeover amendments in general.<sup>333</sup> Therefore, positive abnormal returns are generally observed for target shareholders where the management of the target is hostile to a takeover offer.

Auctions and defensive measures being wealth-enhancing, it has been proved that takeover premiums paid for European targets are twenty five percent less than the

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<sup>327</sup> [citation omitted]

<sup>328</sup> It should be said that the Panel has, in its entire history since 1968, only made use three times of its power to kick off an auction in a takeover situation.

<sup>329</sup> Bebchuk, "The Case Against Board Veto in Corporate Takeovers", *supra* note 32 ("[...] In the event that incumbents use their veto power to defeat bids, shareholders end up worse off compared with the scenario in which the bid would have been accepted" at 992).

<sup>330</sup> Troy, "Control", *supra* note 48 at 135.

<sup>331</sup> *Ibid.*

<sup>332</sup> For a complete study, see Robert Comment & William G. Schwert, "Poison or Placebo?: Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures" (1995) 39 *Journal of Financial Economics* 3.

<sup>333</sup> *Ibid.*; see also Martin Lipton & Paul K. Rowe, "Pills, Polls, and Professors: A Reply to Professor Gilson" (2002) 27 *Del. J. Corp. L.* 1 at 24-25.

price paid for U.S. target companies.<sup>334</sup> Directors clearly use the discretion given to them by the U.S. model to extract a higher price from initial bidders or to buy time to shop for a second bidder. Therefore, granting directors with the necessary powers to lead the negotiations and/or raise defensive measures during the tender offer process protects shareholders from low gains. Also, anticipating on section 3.6 of this Chapter, there is a risk that the strict neutrality rule may create an unequal level-playing field for hostile takeover activity: because directors in the U.S. can use their discretion to obtain a higher premium for their shareholders, the strict passivity rule could consequently put European investors disproportionately on the losing side of under-priced takeovers,<sup>335</sup> and European corporate boards would become powerless to defend themselves against American corporations.

### **3.2. The Myth of Shareholder Activism**

Since the early 1990s, a substantive number of academics have argued that the rise of institutional investors could play somehow a more active role in corporate governance.<sup>336</sup> This phenomenon has participated to one of the Jacksonians' argumentations: because institutions by essence own larger blocks than individuals, and have an incentive to develop specialized expertise in making and supervising investments, they are more likely to acquire the information needed to evaluate "Both the hostile bid and any alternative business plans that the target's directors prefer".<sup>337</sup>

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<sup>334</sup> Clas Bergström et al., "Regulation of Corporate Acquisitions: A Law and Economics Analysis of European Proposals for Reform" (1995) Colum. Bus. L. Rev. 495 at 510.

<sup>335</sup> Further discussions on the unequal level-playing field will be found in Section 3.6, below.

<sup>336</sup> See for e.g. Bernard S. Black, "Shareholder Passivity Reexamined" (1990) 89 Mich. L. Rev. 520; see also Robert C. Pozen, "Institutional Perspective on Shareholder Nominations of Corporate Directors" (2003) 59 Bus. Law. 95 (setting forth that, in 2001, institutional investors held 55.8% of publicly traded equities in the United States).

<sup>337</sup> Bebchuk, "The Case against Board Veto in Corporate Takeovers", *supra* note 32 at 991-94.

More active engagement in corporate governance by institutional investors – able to play a more active role in corporate governance – would substitute for the discipline imposed on directors from the threat of a hostile takeover, and it is assumed that shareholders would consequently be able to make an informed takeover decision.

As an example, Robert Thompson and Gordon Smith based their sacred space argumentation on institutional shareholders.<sup>338</sup>

We certainly recognized the rise of institutional investor activism which has led to the result that shareholders are now more active than they used to be a decade ago.<sup>339</sup> Also, we expect this trend to continue. However, we believe that the place of shareholder activism in the takeover process is commonly inflated. Most authors, based on empirical studies, deny the role of these new shareholders regarding hostile takeovers. A comprehensive and fully reliable survey found relatively little evidence that shareholder activism matters.<sup>340</sup> The well-known Professor Roberta Romano acknowledges that the most popular type of proposal sponsored by institutional investors (between thirty six and forty eight percent of their proposals) involves elimination of takeover defenses, and of these, proposals to rescind poison pills are the overwhelming majority.<sup>341</sup> But the number of such resolutions has declined to an average of less than ten/fifteen a year since 1996 and these very resolutions generally

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<sup>338</sup> Thompson, “Sacred Space”, *supra* note 135 at 47. See more generally Lucian Bebchuk, “The Case for Increasing Shareholder Power” (2005) 118 Harv. L. Rev. 833.

<sup>339</sup> See e.g. Roberta Romano, “Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance” (2001) 18 Yale J. en Reg. 174 (2001) [Romano, “Investor Activism”].

<sup>340</sup> *Ibid.* at 184 (Roberta Romano explained that scholars commend institutional activism in part from a belief that it would replicate the block-holding based governance systems of Germany and Japan and thereby fill the void in managerial monitoring which occurred at the end of the 1980s); see also Bernard S. Black, “Agents Watching Agents; The Promise of Institutional Investor Voice” (1992) 39 U.C.L.A. L. Rev. 811.

<sup>341</sup> Romano, “Investor Activism”, *supra* note 339 at 184; Diane Del Guercio & Jennifer Hawkins, “The Motivation and Impact of Pension Fund Activism” (1999) 52 Journal of Financial Economics 293 (“41% of proposals involved defensive tactics and of these 75% are poison pill proposals” at 298). Sunil Wahal, “Pension Fund Activism and Firm Performance” (1996) 31 Journal of Financial and Quantitative Analysis 1 (“36% of proposals involved defensive tactics and of these 81% are poison pill proposals” at 9)

fail.<sup>342</sup> As a result, she realizes that shareholder activism involving takeover defenses is generally non-value-maximizing.<sup>343</sup> As Stephen Bainbridge affirmed,

“Even the most active institutional investors spent only trifling amounts on corporate governance activism. Institutions devoted little effort to monitoring management; to the contrary, they typically disclaimed the ability or desire to decide company specific policy questions. They rarely conducted proxy solicitations or put forward shareholder proposals. They did not seek to elect representatives to boards of directors. They rarely coordinated their activities.”<sup>344</sup>

Notwithstanding this rise, institutional investors of publicly held companies have not dynamically battled to either limit power control over tender offer defenses or to restrict board’s uses of the pill. Professor Bernard Black offers a set of possible explanations for the insignificance of this activism: first, most proposals are not binding and hence can be ignored by management; second, the level of shareholder proposal activity is low; finally shareholders are unable to organize themselves effectively in order to influence directors or uninformed about what issues to propose.

<sup>345</sup> Also, institutional investors who are best situated to make wise voting decisions may not want to spend money on shareholder activism or offend corporate management.<sup>346</sup> Leo Strine affirmed that “the interests of mutual fund managers are identical to those of their shareholders”.<sup>347</sup> In other words, institutional investors are like any other shareholder; they have not used their considerable political power to

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<sup>342</sup> Kahan, “Love the Pill”, *supra* note 15 at 885-86.

<sup>343</sup> Romano, “Investor Activism”, *supra* note 339 at 190.

<sup>344</sup> Stephen Bainbridge, “Shareholder Activism and Institutional Investors”, online: (2005) SSRN: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=796227](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=796227)>.

<sup>345</sup> Bernard S. Black, “Shareholder Activism and Corporate Governance in the United States” in Newman, Peter, Murray Milgate & John Eatwell, eds. *New Palgrave Dictionary of Money and Finance Markets* (London: MacMillan, 1998).

<sup>346</sup> See Leo E. Strine, Jr., “Towards a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution From Improving Corporate America” (2006) 119 Harv. L. Rev. 1759 (explaining the rise of firms like Institutional Investor Services (ISS) that provide advice on how to vote on corporate ballot issues, to satisfy their legal obligation to vote in an informed manner on behalf of their investors, at 1769).

<sup>347</sup> *Ibid.* at 1770.



advocate for legislative adoption of shareholder choice regimes and it seems that they never will.

### **3.3. The IPOs of American Companies: The Illustration of the Managerialist**

#### **Success**

Because the takeover debate needs some practical illustrations, we analyze in this section recent Initial Public Offering (“IPO”) processes of some American companies. It is widely held that firms at the IPO stage have powerful incentives to adopt arrangements that serve shareholders.<sup>348</sup> One would therefore expect shareholders to make and vote proposals in favor of a shareholder choice, i.e. including provisions restricting board’s ability to adopt poison pills or requiring boards to redeem them in case shareholders decide to support the hostile deal. However, the existing evidence with respect to charter provisions contributing to board veto does not demonstrate pressure for Lucian Bebchuk’s school but instead remain favorable to managerialist proponents. Recent studies show that corporations going public during the past decade have not designed their charters to eliminate board veto. The study led by Robert Daines and Michael Klausner of over three hundred initial public offerings between 1994 and 1997 highlight that more than half of them included anti-takeover provisions in their charters,<sup>349</sup> and over sixty percent of the IPO corporations had charters that strengthened the poison pill.<sup>350</sup> Moreover, the study underlines that no corporation

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<sup>348</sup> Bebchuk, “The Case against Board Veto in Corporate Takeovers”, *supra* note 32 at 1016.

<sup>349</sup> Robert Daines & Michael Klausner, “Do IPO Charters Maximize Firm Value?: Antitakeover Protections in IPOs” (2001) 17 J.L. Econ. & Org. 83 [Daines, “IPO”]; See also Laura Casares Field & Jonathan Karpoff, “Takeover Defenses of IPO Firms” (2002) 107 Journal of Finance 1857.

<sup>350</sup> Kahan, “Love the Pill”, *supra* note 15 at 885.

includes a provision to either limit board authority to adopt anti-takeover provisions in the future, or to prohibit or limit the use of poison pills.<sup>351</sup>

This phenomenon has been found “curious” by most legal and financial scholars.<sup>352</sup> The question remains: “Why, if defenses reduce the corporation’s value, as proponents of the shareholder choice [argue], do companies still adopt substantial defenses prior to IPOs?”<sup>353</sup> Robert Daines and Michael Klausner have raised the possibility that the adoption of such charter provisions resulted from imperfections in the IPO process.<sup>354</sup> Indeed, as Lucian Bebchuk explained,

“When directors have private information about the value of the corporation, and when private benefits to them are positively correlated with the firm value, then companies going public might not offer a charter provision restricting defenses even though such a provision would be optimal”.<sup>355</sup>

We yet adopt a different position. We believe that the existence of anti-takeover provisions in corporate charters at the IPO stage shows that shareholders, in an act of self-paternalism, voluntarily “tie their hands so that they cannot sell to a hostile bidder down the road without target board approval”.<sup>356</sup> Accordingly, it reflects investors’ expectations that the provisions will be used to negotiate a better deal for shareholders if a bid is made. With respect to section 3.1, the board veto generally insures a higher premium. This way, shareholders recognize that they are better off leaving the powers to conduct auctions or to possibly raise takeovers defenses.

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<sup>351</sup> Daines, “IPO”, *supra* note 349 at 95.

<sup>352</sup> Arlen, “Perils”, *supra* note 76 at 601.

<sup>353</sup> John C. Coates IV, “Explaining Variation in Takeover Defenses: Blame the Lawyers” (2001) 89 Cal. L. Rev. 1301 at 1302.

<sup>354</sup> Daines, “IPO”, *supra* note 349 at 86.

<sup>355</sup> Bebchuk, “The Case against Board Veto in Corporate Takeovers”, *supra* note 32 at 1017. As a result, corporations are being unable to signal their value through mechanisms other than the charter provision of takeovers and on the assumption that private benefits are positively correlated with firm value. See Lucian A. Bebchuk, “Asymmetric Information and the Choice of Corporate Governance Arrangements”, online: (2002) SSRN: <<http://ssrn.com/abstract=327842>>.

<sup>356</sup> Daines, “IPO”, *supra* note 349 at 84-85.

### 3.4. Embedded Defenses: “the Perils of Shareholder Choice”<sup>357</sup>

In our pledge to prove that the managerialist form – and therefore the Delaware model – is best for target shareholders, Jennifer Arlen and Eric Talley’s recent article deserves particular attention. In *Unregulable Defenses and the Peril of Shareholder Choice*,<sup>358</sup> the two scholars portrait what the board’s behavior would be, had a shareholder choice been enforced. The outcome is quite remarkable: in such circumstances, it is argued that managers can simply entrench themselves further by employing pre-bid defenses embedded in the corporation’s contractual arrangements. This existing incentive to substitute out of regulated pure defenses into unregulated embedded defenses would eventually work against shareholders’ own interests.<sup>359</sup>

Whereas pure defenses are measures whose only purpose and effect are to deter hostile bids – classic example is the poison pill which has indeed no effect on the value of the firm except to the extent that it discourages hostile takeovers – pre-bid embedded defenses are actions the board takes for legitimate business reasons and that can sometimes have the effect of deterring tender offers.<sup>360</sup> The most notable example of pre-bid embedded defenses includes the change of control provisions in third party contracts. This type of provisions usually protects third parties from the consequences of a change of control by granting them either a financial payoff or a termination right in the event of a change of control or a corporate combination. In general, they are used by banks which grant loans, in order not to get burned in case of a leverage buy-out for instance. According to the authors, directors would agree on these very clauses to make the company less attractive, regardless of shareholders’ interests. If a strict shareholder choice was to be enforced, directors would draft them very broadly in

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<sup>357</sup> Arlen, “Perils”, *supra* note 76.

<sup>358</sup> *Ibid.*

<sup>359</sup> *Ibid.* at 581.

<sup>360</sup> *Ibid.* at 590.

order to apply to both friendly and hostile offers, as provisions targeted at hostile deals would be treated as invalid pure defenses.<sup>361</sup> Therefore, it would still be possible to use embedded defenses into a host of seemingly ordinary business transactions, with the effect of deterring subsequent bids.

The direct outgrowth of the pre-bid embedded defenses is the cost. Indeed, these defenses are more costly for shareholders than pure defenses are, since pure defenses only deter hostile deals whereas substitute embedded defenses often deter friendly *and* hostile deals alike. Defense substitution is an unavoidable cost of strict shareholder choice, as even under the strongest shareholder choice regime, managers still retain authority to adopt pre-bid embedded defenses. The fear of hostile takeovers being too strong, it seems to us that directors would sacrifice the company and would rather eliminate the possibility of a bid (either hostile or not) than being the target of hostile bids. As a result, post-bid embedded defenses may reduce the likelihood that the directors will be able to eventually negotiate a friendly deal.

There is an important factor that shareholder choice proponents should worry about: because shareholders often explicitly approve the power granted to boards to employ these mechanisms, courts would not easily invalidate them:

“Pre-bid embedded defenses are extraordinarily difficult to regulate because (1) they are adopted within the abstract, information-poor context of everyday business, often far before a tender offer might ever emerge; and (2) they ostensibly serve legitimate business interests and may confer benefits on the firm that exceed any negative effects associated with their effect on takeovers”.<sup>362</sup>

In fact, change of control provisions are difficult for courts to regulate because many are used to enhance firm value by appeasing legitimate concerns of third parties. Any

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<sup>361</sup> Jennifer Arlen, “Regulating Post-Bid Embedded Defenses: Lessons from Oracle versus PeopleSoft”, online: (2006) SSRN: <<http://ssrn.com/abstract=921833>>.

<sup>362</sup> Arlen, “Perils”, *supra* note 76 at 596.

effort to expand shareholder choice to eliminate the use of such provisions could harm those firms which benefit from their use.<sup>363</sup> Therefore, courts cannot regulate these effectively without interfering in the everyday management of publicly held firms. Managers can thus alter how the corporation is structured and financed in ways that enable them to retain considerable control.

The last question the authors ask themselves is the plausibility of such behavior.<sup>364</sup> They affirm that even under the strongest shareholder choice regime, managers will almost certainly have access to these unregulated defenses.<sup>365</sup> Jennifer Arlen and Eric Talley explain that there are two reasons to believe that embedded defenses would pose a threat under a shareholder choice regime. Firstly, as we have seen, courts are poorly positioned to regulate managerial decisions made outside of the context of a tender offer. Secondly, managers would almost certainly have strong incentive to employ (indeed invent) unregulated embedded defenses under a shareholder choice regime since, from a management perspective, a shareholder choice regime would effectively transform all acquisitions into hostile ones, as “acquirers would no longer need to bid for managerial support of a takeover bid”.<sup>366</sup>

As the authors state, it is not possible to make a general case for the superiority of shareholder choice over rules granting boards considerable veto power over hostile tender offers.<sup>367</sup> However, we might make some predictions and the article is driven by the belief that the history of acquisitions and takeover defenses is one designed by managers continually adapting new defenses to meet new threats to their control.<sup>368</sup> Therefore, the shareholder choice model will open the doors to embedded pre-bid

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<sup>363</sup> *Ibid.* at 628-32 (discussing circumstances under which managers may respond to a strong shareholder choice regime by adopting embedded measures that deter friendly and hostile deals alike).

<sup>364</sup> For the formal analysis, see *Ibid.* at 613.

<sup>365</sup> *Ibid.* at 623.

<sup>366</sup> *Ibid.*

<sup>367</sup> *Ibid.* at 583.

<sup>368</sup> *Ibid.* at 642.

defenses that are counter-productive, harmful for shareholders, which impose little direct cost on the firm, and which can not be regulated.

### **3.5. The Opt-out Rule: the Risk of An Unequal Level-Playing Field For Cross-Atlantic Takeover Activity**

The real controversial problem about takeover regulation in Europe has always been anti-takeover defenses.<sup>369</sup> The neutrality rule originally drafted caused heated debate and threatened the new directive with the same fate as the previous draft.<sup>370</sup> Since allowing board control is better for shareholders – as we are trying to convince the reader in this Chapter – some European countries, of which Germany comes first, opposed a rule prohibiting directors from opposing a takeover. To make their opinions heeded, but also to make the directive “politically viable”,<sup>371</sup> a little twist, known as the Portuguese Compromise, was needed. The opt-out rule set forth in Article 12 §1 was adopted, in which member states retain the freedom to opt out of the directive’s most contentious requirements, i.e. the neutrality and the break-through rules: “Member States may reserve the right not to require companies as referred to in Article 1(1) which have their registered offices within their territories to apply Article 9(2) and (3) and/or Article 11”.<sup>372</sup> In other words, the article makes the provision on restrictions on defensive tactics (Article 9) and those regarding breakthrough rules (Article 11) optional. Regarding the neutrality rule, this opt-out rule therefore allows for three scenarios:

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<sup>369</sup> Klaus J. Hopt, “Takeover Regulation in Europe - The Battle for the 13th Directive on Takeovers” (2002) 15 Australian Journal of Corporate Law 1.

<sup>370</sup> Scott Simpson et al., “The Future Direction of Takeover Regulation in Europe” (2005) 1520 PLI/Corp 759 at 761-62 [Simpson, “Takeover Regulation in Europe”].

<sup>371</sup> Theobald, “Hostile Takeovers”, *supra* note 62 at 33.

<sup>372</sup> Directive, art. 12 §1, *supra* note 15.

- (1) First, member states can refuse to adopt the board neutrality provision, but then must allow companies with its borders to individually opt-in to Articles 9 of the directive (the neutrality requirement).<sup>373</sup> This situation is very much like the one Lucian Bebchuk and Allen Ferrell has advocated for the U.S. takeover regulation, in which they proposed a system whereby the federal government would set up rules focused on more shareholder power, especially providing a role in defensive tactics, and allow the shareholders of a corporation to opt into that system.<sup>374</sup>

The next two scenarios surround the idea of reciprocity, by which member states can decide whether to relax the prohibitions and restrictions arising out of the board neutrality rule in the event a bid is made by a company which is not subject to the same prohibitions and restrictions. Article 12§3 of the directive states that:

“Member States may, under the conditions determined by national law, exempt companies which apply Article 9(2) and (3) and/or Article 11 from applying Article 9(2) and (3) and/or Article 11 if they become the subject of an offer launched by a company which does not apply the same Articles as they do, or by a company controlled, directly or indirectly, by the latter, pursuant to Article 1 of Directive 83/349/EEC”.<sup>375</sup>

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<sup>373</sup> Ventoruzzo, “Contrasts”, *supra* note 7 at 66.

<sup>374</sup> Lucian Bebchuk and Allen Ferrell have argued that competition among states in regulating takeovers leads to inefficient solutions because states have an interest in protecting local corporations against “discipline” that might be imposed by an active market for corporate control: “The authors propose that shareholders be allowed to opt-in to the federal regime. In this way, shareholders would be able to signal their preferences for more or less protective regulation. The distinctive feature of their proposal, and the aspect that makes it very close to the approach followed by the European Union, is that their proposed solution is not a mandatory federal regime, but rather an optional regime that individual states can adopt” See Lucian A. Bebchuk & Allen Ferrell, “A New Approach to Takeover Law and Regulatory Competition” (2001) 87 Va. L. Rev. 111 at 177.

<sup>375</sup> Directive, art. 12 §3, *supra* note 15. For more information on the reciprocity rule, and in the ways it addresses uninhibited protectionism, see Matteo Gatti, “Optionality Arrangements and Reciprocity in the European Takeover Directive” (2005) 6 European Business Organization Law Review 553 (“Although the [Directive] failed the goal of promoting a strong takeover market by limiting the availability of defensive tactics, both the optionality and the reciprocity features will represent an intriguing test of how Member States will address the underlying policy choices and, where they chose to opt out of the board neutrality rule and/or the break-through rule, of how companies will react to the possibility of deciding to opt into the pro-takeover EC default regime” at 553-54) [Gatti, “Optionality”].

In other words, member states can exempt target companies which apply the defensive measure rules from the requirements of those rules when they are faced with a bidder who does not apply the rules. Corporations can request an exemption from board neutrality so that they can apply defensive tactics; however, they must receive permission for this exemption from the member state and cannot engage in reciprocity by its own.<sup>376</sup> Thus, the two last scenarios will be:

- (2) Second, the member state would adopt Article 9 – the neutrality requirement – but exempt companies from following the requirements of this article when faced with a foreign bidder who is not subject to those same requirements because its home jurisdiction did not opt-in.<sup>377</sup>
- (3) Third, the member state can opt-into the requirements and not allow reciprocity.<sup>378</sup>

We appreciate the opt-out rule since it is a breach of the managerialist model into the traditional, shareholder choice-oriented European corporate law. However, most of European scholars believe that it deteriorates its harmonizing potential.<sup>379</sup> According to a majority, it is yet to be seen whether or not the directive will provide the cohesive system it was designed to promote or if its harmonizing goals will instead remain a fiction “Among the diverse web of national law”.<sup>380</sup> It is in many ways a compromise that diluted previous projects by leaving significant regulatory freedom to national legislatures. European Commissioner Frits Bolkestein said that it took the “Key ingredient out of the directive and nullified the Europeans’ hopes of becoming the top

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<sup>376</sup> Directive, art. 12 §4, *supra* note 15.

<sup>377</sup> Ventrone, “Contrasts”, *supra* note 7 at 66.

<sup>378</sup> *Ibid.*

<sup>379</sup> Simpson, “Takeover Regulation in Europe”, *supra* note 370 at 761-62.

<sup>380</sup> Theobald, “Hostile Takeovers”, *supra* note 62 at 33.



world economy”.<sup>381</sup> Some commentators have even expressed doubts about whether the directive effectively harmonizes the most important aspects of takeover regulation.<sup>382</sup>

We do not attempt to make predictions on the success of the directive. We are far more concerned about the application of the reciprocity clause which makes the directive an important consideration for U.S. regulators and policymakers; for instance, a U.S. corporation that is not subject to the passivity rule would fall in the reciprocity exception and might not be able to exploit directors’ passivity in order to complete a hostile takeover. We are here dealing with the second scenario, in which the Ford Company would be willing to takeover a French car manufacturer, e.g. Renault. Because of the reciprocity rule, it seems a priori that directors of the European company will have the right to erect defensive measures, as a consequence of article 12 of the directive. However, as some German scholars affirmed, it remains a question, because of international agreements like GATS, whether the reciprocity clause can be used against non-member nations like the U.S.<sup>383</sup> If not, there is a risk that the strict neutrality rule may create an unequal level-playing field for hostile takeover activity, at a cross-Atlantic scale. European corporate boards would be powerless to defend themselves against American corporations that have the power to defend themselves; and because directors in the U.S. can use their discretion to obtain a higher premium for their shareholders, the strict passivity rule could consequently put European “Investors disproportionately on the losing side of under-priced takeovers”.<sup>384</sup>

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<sup>381</sup> “The EU’s Takeover Plan” (26 November 2003) *Washington Times*, online: The Washington Times: <<http://www.washtimes.com/op-ed/20031125-082611-8252r.htm>>.

<sup>382</sup> See Gatti, “Optionality”, *supra* note 379 (“it would have made more sense not to have provided anything and to have left Member States with complete freedom to regulate the subject matter” at 560).

<sup>383</sup> See Silja Maul & Athanasios Koulouridas, “The Takeover Bids Directive” (2005) 5(4) *German Law Journal* 355.

<sup>384</sup> Christian Kirchner & Richard W. Painter, “Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform” (2002) 3 *Am. J. of Comp. L.* 451.

It is rightfully argued that European rule strictness could increase political pressure on member states to pass barriers to hostile takeovers, and support stakeholders to make a political case to regulators rather than an economic case to directors.<sup>385</sup> Given that the U.S. system allows directors more leverage to consider non-shareholders' interests, European directors would rely on government regulators to demand that acquirers take into account other beneficiaries – national interests for example – as soon as a takeover bid is announced. In this context, France has already taken a very proactive stance against hostile takeovers by adopting a decree on 31 December 2005 enabling the government to veto or impose conditions on foreign takeovers in eleven strategic sectors.<sup>386</sup> This action was clearly made under economic patriotism. Moreover, in the wake of Mittal Steel's hostile bid for Arcelor, France drew up fresh legislation allowing companies facing a hostile bid to make themselves more expensive to acquire, by giving them the right to issue warrants convertible to shares at a discounted price to their shareholders during the offer.<sup>387</sup>

As a result, member states decide to inexpertly legislate in order to reach a goal that could be achieved expertly by corporate boards. The strict neutrality rule is a pipe-dream. Under a shareholder choice model, incumbent directors and every interested person will have to turn to politicians to fend off hostile bidders anyway.<sup>388</sup> This reality has been caught by Germany which opted for a managerialist model.

### **3.6. The German Case: The Illustration of the Limits of the Neutrality Rule**

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<sup>385</sup> *Ibid.*

<sup>386</sup> André Nilsen, "The EU Takeover Directive and the Competitiveness of the European Industry", online: The Oxford Council on Good Governance (2004): <http://www.oxfordgovernance.org/fileadmin/Publications/EY001.pdf>.

<sup>387</sup> See ISS International Corporate Governance Policy 2007 Updates, online: (2007) ISS website: <http://www.issproxy.com/pdf/2007%20International%20Policy%20Update.pdf> at 9.

<sup>388</sup> Kirchner, "European Modified Business Judgement Rule", *supra* note 11 at 360.

Historically, Germany has always followed the U.K. City Code model regarding director neutrality in tender offers and basically relied on its block shareholdings to counter hostile offers.<sup>389</sup> Recently however, the country decided to remain independent from the European passivity wave. All began in April 2001, when representatives of German top companies praised for modifications of the 12<sup>th</sup> directive directly to the German Chancellor. The German authorities were anxious about more controversial takeovers that liberalization might lead to, as well as perceived injury from hostile takeovers to non-shareholder stakeholders (employees, customers, suppliers and the community) that would be exacerbated if more European companies could be taken over by American companies than vice versa.<sup>390</sup> Professor Tyler Theobald explains the German feeling towards the neutrality requirement very well:

“The Directive would have increased much needed European restructuring by opening up the corporate takeover market, allowing the break-up of conglomerates in favor of concentration and specialization. Further, by offering better investment and shareholder protection, it would have made the E.U. markets more attractive, thereby bringing in more foreign investment and venture capital to help the needy technology sector. The absence of such shareholder protection makes the E.U. markets less desirable than the U.K. or U.S. markets”.<sup>391</sup>

For these reasons, Germany gave its boards of directors the powers they needed to defend against hostile takeovers in late 2001.<sup>392</sup> Section 33 of the German Securities and Acquisitions Act (“German Act”) directly rejects the directive neutrality principle

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<sup>389</sup> Theobald, “Hostile Takeovers”, *supra* note 62 at 52.

<sup>390</sup> Kirchner, “European Modified Business Judgement Rule”, *supra* note 11 at 391. We do not mention in this thesis the academic debate over whether hostile takeovers actually harm non-shareholder stakeholders. Especially, German non-shareholder stakeholders might fear that American bidders would have less incentive to protect them than do European bidders constrained by European law and a European tradition of stakeholder inclusion in corporate governance.

<sup>391</sup> Theobald, “Hostile Takeovers”, *supra* note 62 at 36.

<sup>392</sup> See Jeffrey N. Gordon, “An American Perspective on the New German Anti-takeover Law”, online: (2002) SSRN: <<http://ssrn.com/abstract=336420>> at 3 [Gordon, “German Law”].

in favor of giving the boards the power to defend against hostile takeovers. Section 33(1) allows management to implement limited defensive measures with the approval of the supervisory board and without first getting shareholder approval.<sup>393</sup> Section 33(2) adds to the powers above by giving the board an alternate source of authority, the shareholders, allowing them at the shareholders meeting to grant the board the authority to implement defensive measures prior to any known tender offer, with such authorization being renewable every 18 months.<sup>394</sup> It is important to mention that this mandate does not allow the U.S. board's weapon of choice, the poison pill.<sup>395</sup>

The German Act leaves obviously ample room for defensive measures by the management board if the supervisory board gives its consent, despite the neutrality wave that spread in Europe. It is no surprise then that Germany opts out of the rule prohibiting directors from opposing a takeover. Critics argue that Germany, in enacting this legislation, has participated in a U.S. style race to the bottom, largely fostered by labor union fears regarding the perceived negative effects of hostile takeovers on codetermination.<sup>396</sup> To some scholars, these laws restricted the openness of the market for corporate control, which scholars see as crucial to modernizing corporations in Europe, and ultimately to lead to greater competitiveness in the global economics and politics.<sup>397</sup>

What is remarkable for our paper is that this position indicates that the neutrality rule goes beyond capital markets differences. The reader might have thought that the differences in ownership patterns mean that different forms of takeover legislation are

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<sup>393</sup> German Securities and Acquisitions Act (2001) at §33(1)

<sup>394</sup> *Ibid.* at §33(2).

<sup>395</sup> Gordon, "German Law", *supra* note 392 ("Some critics argued that the lack of a poison pill may be detrimental to German companies because it may leave the boards with no choice but to use the permitted value-reducing measures, such as selling significant assets, which can ultimately lead to the "destruction of the firm in order to save it" at 5-6)

<sup>396</sup> Christian Kirchner & Richard W. Painter, "Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform" (2002) 3 Am. J. of Comp. L. 451 at 467.

<sup>397</sup> Gordon, "German Law", *supra* note 392 at 8.

required. In other words, one may believe that the concentrated ownership that is in place in continental European jurisdictions justified to some extent a neutrality rule. Indeed, putting control of the defensive tactics in the hands of directors in many corporations in Europe would be pointless since European corporations are managed by a major shareholder who potentially own a majority of the stock and can thus play with the bidder(s) and use the defensive tactics as he/she pleases. But Germany enacted laws against the principles espoused in the failed directive and more inline with U.S. style board defensive powers. We believe that Germany did not want to rely too much on block shareholdings to counter hostile offers, since such a market structure can change over time. That most corporations in Europe can rely on block-shareholders is not right anymore. It seems that in Europe, arguments for the strict neutrality rule were empirically but mistakenly based on England's positive experience with the City Code.<sup>398</sup> Europeans countries believed that their capital markets were strong enough to work without any directors' help. We believe that German lawmakers became aware of the managerialist benefits developed above and finally opted for an American role of directors, even though these developments were seen as potentially damaging to Europe as a whole.

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<sup>398</sup> Kirchner, "European Modified Business Judgement Rule", *supra* note 11.

## Conclusion

If there was one acid test that could show up the difference between U.S. and European corporate laws, it would without a shadow be the role of directors in the event of a takeover bid.<sup>399</sup> Delaware's courts have established through twenty years of case law a regime in which directors are given substantial authority to forge corporate strategies, granting them with powers to veto or to adopt defensive measures thereby distrusting shareholder decision-making. In other words, in the U.S., "The director-centered model won [the Eighties debate on takeover rules]".<sup>400</sup> However, the jurisprudence remains unclear as to whom these powers are granted for, i.e. the shareholders or the corporation. On the contrary, the European Community enforces a neutrality rule which recognizes Lucian Bebchuk's ideas but is no more than a pipe dream. Yes, directors' flexibility under the modified business judgment rule may be sometimes abused. But shareholders of American companies will most of the time enjoy higher premiums – among other reasons – and there is statistical evidence that the market for corporate control in the United States functions reasonably well.<sup>401</sup> Because every industry faces a "sell" decision at some point,<sup>402</sup> we seriously advise the investors to put their money in U.S. companies, whereby an active role of

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<sup>399</sup> Reinier Kraakman once affirmed that "Despite the commonality of the issue, the UK [and therefore Europe] and the US have made almost diametrically opposed choices on how to regulate hostile takeovers" in Reinier H. Kraakman, *The Anatomy of Corporate Law, A Comparative and Functional Approach* (Oxford: Oxford University Press, 2004), at 164.

<sup>400</sup> Leo E. Strine, Jr., "Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements" (2001) 56 Bus. Law. 919 at 925. See also Martin Lipton & Paul K. Rowe, "Pills, Polls, and Professors: A Reply to Professor Gilson" (2002) 27 Del. J. Corp. L. 1 ("The view that Professor Gilson, and the other critics of the current Delaware rules, are wrong" at 1).

<sup>401</sup> See Kirchner, "European Modified Business Judgement Rule", *supra* note 11 at 326.

<sup>402</sup> Sherman, Andrew J. & Milledge A. Hart, *Mergers and Acquisitions From A to Z* (New York: American Management Association, 2006) at 73.

corporate directors in event of hostile takeovers would protect them better than in European companies.<sup>403</sup>

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<sup>403</sup> As a matter of fact, it seems that some authors suggest that the modified business judgement rule, because it is more flexible than the strict neutrality rule, should be introduced in Europe. See Christian Kirchner, Richard W. Painter, "Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform" (2002) 3 Am. J. of Comp. L. 451.

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