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**WHO WRITES THE RULES FOR HOSTILE TAKEOVERS, AND WHY?  
THE PECULIAR DIVERGENCE OF US AND UK TAKEOVER  
REGULATION**

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REGULATION**

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## **Abstract**

Hostile takeovers are commonly thought to play a key role in rendering managers accountable to dispersed shareholders in the “Anglo-American” system of corporate governance. Yet surprisingly little attention has been paid to the very significant differences in takeover regulation between the two most prominent jurisdictions. In the UK, defensive tactics by target managers are prohibited, whereas Delaware law gives US managers a good deal of room to maneuver. Existing accounts of this difference focus on alleged pathologies in competitive federalism in the US. In contrast, we focus on the “supply-side” of rule production, by examining the evolution of the two regimes from a public choice perspective. We suggest that the *content* of the rules has been crucially influenced by differences in the *mode* of regulation. In the UK, self-regulation of takeovers has led to a regime largely driven by the interests of institutional investors, whereas the dynamics of judicial law-making in the US have benefited managers by making it relatively difficult for shareholders to influence the rules. Moreover, it was never possible for Wall Street to “privatize” takeovers in the same way as the City of London, because US federal regulation in the 1930s both pre-empted self-regulation and restricted the ability of institutional investors to coordinate.

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

## I. INTRODUCTION

A distinguishing feature of the so-called “Anglo-American” system of corporate governance is that share ownership in public corporations is dispersed. The authors of the leading empirical studies on corporate ownership note, for instance, that “in the United States and the UK ... [even medium-sized] firms remain widely held—a testimony to the attractiveness of selling out in the United States and the UK.”<sup>2</sup> A key mechanism for rendering managers accountable to shareholders is the market for corporate control: namely, the threat that if the managers fail to maximize the share price, the company may become an acquisition target. Given that this mechanism is thought to be pivotal to making dispersed ownership viable, it is strange that so little attention has been paid to the significant differences in the way in which takeovers are regulated *between* the two systems that together comprise the “Anglo-American model.” Both the *mode* and the *substance* of the regulation are startlingly different.

In the UK, takeovers are regulated by the City Code on Takeovers and Mergers (the “Takeover Code”), a body of rules that is written and administered by the Panel on Takeovers and Mergers (the “Takeover Panel”). Staffed by personnel on secondment from the professional community that it regulates, and untrammelled by the procedural and precedential niceties of the courtroom, the Panel responds in a flexible and well-informed fashion to disputes and governs their resolution in “real time.” In contrast, most US takeovers are governed by the courts of Delaware. As courts go, these are quick and flexible, but they nevertheless tend to lend an *ex post* flavor to dispute resolution.

The content of takeover regulation differs just as markedly on the two sides of the Atlantic. In the UK, the Takeover Code is strongly weighted towards protecting the interests of shareholders. The Code’s equal treatment and mandatory bid requirements prevent acquirors from making coercive bids. Moreover, unless shareholders consent, the Code strictly prohibits management from employing any defensive tactics that would have the effect of frustrating an actual or anticipated bid. In contrast, management in the US have a good deal more flexibility to engage in defensive tactics, provided that these can be justified in accordance with their fiduciary duties.

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<sup>1</sup> ECONOMIST, Oct 31 1959, 140.

<sup>2</sup> Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 497 (1999).

These differences raise a number of interesting questions. First, how are the divergences between these two superficially similar systems to be explained? At the level of substance, why is Delaware's jurisprudence so much friendlier to managers than the British Takeover Code? In answer, some scholars point to the dynamics of competitive federalism in the US. In an environment characterized by regulatory competition, the winning "product"—that is, Delaware law—will reflect the preferences of the group which do the "buying." In the view of Lucian Bebchuk and others, the managers of listed corporations have undue influence over the choice of corporate governing law, and hence, it has tended to favor their cause in takeovers.<sup>3</sup>

In contrast, our account does not require an assumption that US managers have effective control over the choice of corporate law—the veracity of which is, of course, a hotly contested question. Rather, we suggest that the *mode* of regulation has influenced—indeed, determined—its *substance*. The substance—shareholder centered regulation in the UK, significant managerial discretion in the US—is closely linked to the emergence of self-regulation as the regulatory strategy of choice in the UK, and to judicial oversight in the US.

To reconstruct the history of British takeover regulation, we interviewed members of the Takeover Panel and surveyed contemporary newspaper accounts dating back to the 1950s, when hostile takeovers first emerged.<sup>4</sup> In the UK, the self-regulatory system was orchestrated principally by the community of investment bankers and institutional investors, all of whom regularly rub shoulders in the "City," the one square mile district where London's business community is located. Corporate managers were not a well-organized constituency, and they had, from an American perspective, surprisingly little say in the formulation of the regulation. Hence it is hardly surprising that the rules were designed to protect the interests of shareholders. In the US, on the other hand, the development of the rules has depended upon the accumulation of

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<sup>3</sup> See, e.g., Lucian Arye Bebchuk & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 BUS. L. 1047 (2002); Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001). In his important and much publicized work arguing for more shareholder choice in American corporate governance, Bebchuk is one of the few corporate scholars who have even noticed the very different, more shareholder-centered approach to corporate governance. Bebchuk focuses on the substance of the regulation, without delving into the strikingly different modes of regulation in the US and UK. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 847-50 (2005). The difference in mode, we will argue, holds the key to understanding takeover regulation in the two countries.

<sup>4</sup> The interviews were conducted in January and February 2005 by Armour and Jay Verjee. Jay did a masterful job both with the interviews and in constructing an initial history of the Takeover Panel.

common law precedents.<sup>5</sup> The crucial point to understand here is that judges can only decide the cases which are brought before them—thus, the evolution of the common law depends upon the incentives parties have to litigate as opposed to settle disputes. Where particular groups of litigants are better-organized or funded than others, the content of the law may be expected, over time, to develop in a manner favorable to their interests. In litigation over takeover disputes, directors have just such an advantage, because of the structure of takeover litigation. This claim, it should be understood, is not so much one about Delaware as about the common law—and it is buttressed by a remarkable parallel in the UK: English caselaw—which was the only source of regulation until the matter was “privatized” by the advent of the Takeover Code in the late 60s—is similarly manager-friendly. Indeed, several of the cases sound as if they might have been written by Delaware judges.

This leads naturally to a related question: if the substance of the regulation is determined by its mode, how in turn are the differences in process to be explained? In London, City professionals—in particular, institutional investors—avoided the need for *ex post* litigation by developing a body of norms, enforced by reputational sanctions, which ensured that contentious issues were resolved *ex ante* without the need for court involvement. On Wall Street, by contrast, self-regulation never took hold in the same way. At first blush, the absence of self-regulation by institutional shareholders in the US may seem simply to reflect the fact that ordinary investors account for a much more significant proportion of stock ownership in the US than the UK, and consequently US institutional investors have never risen to own a similar proportion of listed stock as have their UK counterparts. As a result, coordination is less worthwhile for such investors, each of whom holds relatively little stock, and self-regulation is less likely to emerge.

Such a story, however, misses what we believe to be the crucial role of law in structuring these developments. As Mark Roe and others have described,<sup>6</sup> US federal regulation in the ‘30s and before restricted both the scale and the scope of services that financial institutions were permitted to provide, crucially undermining the ability of institutional investors to coordinate. This led not only to the relatively limited stock ownership by institutional as compared to retail

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<sup>5</sup> For our assessment of the US regulatory framework, we analyzed primary and secondary materials from the New Deal era, studied the legislative history of the 1968 Williams Act and primary materials charting the 1967 amendments to the Delaware General Corporation law, researched contemporary newspaper accounts, and drew from a variety of other sources.

<sup>6</sup> See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994); Bernard S. Black & John C. Coffee, *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICHIGAN L. REV. 1997 (1994).

investors, but also to an environment that was hostile to self-regulation. Indeed, federal securities legislation enacted during the same era directly prohibited the New York Stock Exchange, the principal source of self regulation in the 1930s, from seeking to regulate a range of activities that have fallen within the purview of “soft law” in London. In the UK, by contrast, restrictive personal taxation, coupled with a safe harbor for pensions, greatly accelerated the development of collective investment vehicles. The UK’s self-regulatory system was driven by the preponderance of institutional investors in the marketplace, and a regulatory framework that trusted them to govern themselves; whereas the US was characterized by many more retail investors and a popular mistrust of the “insiders” who controlled the financial institutions, reflected in the latter’s being kept for so long on a tight regulatory leash.

These issues of regulatory development raise a normative question: does one system have properties that make it preferable to the other? Previous scholars have paid little attention to the substantive differences between the two regimes, and almost none to the far more important divergences in the mode of regulation. We consider that the UK’s system has *prima facie* advantages in terms of procedure—it seems at once quicker, cheaper, and more certain than a system that relies upon litigation. Turning to substance, much ink has of course been spilled on the question of whether, and to what extent, defensive tactics should be permissible in the face of a hostile bid. We consider that the Takeover Code’s “no frustrating action” rule is likely to be preferable, but recognize that the state of the empirical literature is such that we cannot make this claim emphatically.

Our account of the differences in the development of the two systems suggests that the choice of rule-maker—judges or self-regulatory bodies in this instance—can be just as important an influence on the substance of takeover law as regulatory competition. This has important implications for the future development of European takeover law. Issues of competitive federalism are becoming much more pertinent on the other side of the Atlantic in the light of the European Court of Justice ruling in the *Centros* case and the passing of the pro-choice Takeover Directive, each of which has increased the potential for regulatory competition in European company law.<sup>7</sup>

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<sup>7</sup> See generally Jens C. Dammann, *Freedom of Choice in European Company Law*, 29 YALE J. INT’L L. 477 (2004); Martin Gelter, *The Structure of Regulatory Competition in European Corporate Law*, 5 J. CORP. L. STUD. 247 (2005); Tobias H. Tröger, *Choice of Jurisdiction in European Corporate Law: Perspectives of European Corporate Governance*, 6 EUR. BUS. ORG. L. REV. 3 (2005); John Armour, *Who Should Make Corporate Law? EU Legislation vs. Regulatory Competition*, 58 CURR. LEG. PROB. 369 (2005) (available as ECGI Law Working Paper No 54).

These developments, together with the increasing ownership of UK companies by non-UK institutions and the belated emergence of institutional shareholders as a force in US corporate governance, pose a final question for US and UK governance: will the current differences endure? One can imagine the increasingly heterogeneous investment culture in the UK undermining UK self-regulation, and institutional shareholders pressing for a more shareholder-centered approach in the US. But we suspect that the basic differences are deeply entrenched enough to survive even the radical changes that are underway in global securities markets.

The rest of this paper is structured as follows. Section II describes the differences between the US and UK systems of takeover regulation, and offers a comparative evaluation of the divergent processes and substance of takeover regulation in the two countries. Section III gives a historical account of their development. The reasons for their divergence are explored in Section IV. Section V explores some of the implications of the two approaches and speculates whether each is likely to endure. Section VI concludes.

## II. TWO DIFFERENT SYSTEMS OF TAKEOVER REGULATION

Hostile takeovers are the nuclear threat of corporate law, the most dramatic of all corporate governance devices. A properly functioning takeover market enhances corporate governance in two related ways. If the bidder brings in better managers after the bid, or can improve the target's performance by reconfiguring its assets or exploiting synergies between the two firms, there is a direct, cause-and-effect relationship between the takeover and firm value. Takeovers have a second, indirect benefit as well. If managers have reason to suspect that a hostile bidder will swoop in and take control if they run the company badly, the prospect of a takeover can keep the managers on their toes.

For over twenty-five years, academics have debated the question of how best to regulate the takeover market. The-more-the-merrier, argued Frank Easterbrook and Dan Fischel. Their passivity thesis proposed that managers be prohibited from defending against a takeover, so that the company's shareholders would be the ones who decided whether to accept the bid.<sup>8</sup> If the decision were left to the

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<sup>8</sup> Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991). The Easterbrook and Fischel approach has antecedents in the work of earlier scholars such as Henry Manne in the 1960s: see Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). See also Ronald Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).



target's managers, the managers' interest in preserving their own jobs would too often overcome their fidelity to the best interests of the company. In response, other commentators argued that managers should be given at least some scope to slow down an initial takeover bid.<sup>9</sup> On this view, managers should be permitted to defend against a takeover to the extent necessary to get the best possible price for the company's shareholders.

In the United States, Easterbrook and Fischel's shareholder-oriented approach has been far more successful in theoretical debates than as an influence on actual practice. The Delaware courts have dismissed the shareholder choice perspective in several important takeover decisions, emphasizing instead that the company is managed by or under the control of its directors.<sup>10</sup> If we look across the Atlantic, by contrast, we see a remarkably different picture. The UK has explicitly rejected managerial discretion in favor of the shareholder-oriented strategy for regulating takeovers. Less recognized but of even greater importance, the *mode* of takeover regulation also looks quite different in the UK than in the US. In the discussion that follows, we describe the differences in more detail, and consider whether either approach can be said to be superior.

#### A) The Substantive Contours of Takeover Regulation

Start with the substantive terms– the “what”– of takeover regulation. United States regulation gives bidders complete flexibility to bid for as small or as large a percentage of the target company's stock as they wish. US law has never imposed a “mandatory bid” rule requiring bidders who acquire a large block of target shares to make an offer for all of the target company's shares. US tender offer regulation does require, however, that the bidder pay the same price for each of the shares it acquires; that the bidder purchase a pro rata amount of the shares of each shareholder who tenders her shares; and that it keep the bid open for at least twenty days.<sup>11</sup> The US regulations thus protect shareholders against so-called “Saturday night special” bids that were kept open only for a short time and made available only to the first shareholders who tendered in order to create

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<sup>9</sup> See, e.g., Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); John C. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Takeover's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984); Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002).

<sup>10</sup> Footnote 14 of one of Delaware's most pro-takeover decisions, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173 (Del. 1985), for instance, is at pains to disclaim the Easterbrook and Fischel perspective, emphasizing that “we do not embrace the passivity thesis rejected in *Unocal*.”

<sup>11</sup> The principal US tender offer regulations were enacted in connection with the 1968 Williams Act, which amended the Securities and Exchange Act of 1934. For a brief summary of the regulations, see MELVIN A. EISENBERG, *CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS* 1136-40 (8<sup>th</sup> ed. Unabridged 2000).

pressure on shareholders to rush to tender. But they do not guarantee shareholders that they will be able to sell all of their shares if a bidder takes control of the company.

While US regulation of tender offer bidders is relatively shareholder-friendly, the treatment of target managers' responsibilities in the face of an unwanted takeover bid is anything but. Managers of a target company are permitted to use a wide variety of defenses to keep takeover bids at bay. The most remarkable of the defenses is the poison pill or shareholder rights plan, which is designed to dilute a hostile bidder's stake massively if the bidder acquires more than a specified percentage of target stock— usually 10 or 15%. Poison pills achieve this effect— or more accurately, would if they were ever triggered— by, among other things, inviting all of the target's shareholders except the bidder to buy two shares of stock for the price of one. The managers of a company that has both a poison pill and a staggered board of directors have almost complete discretion to resist an unwanted takeover bid.<sup>12</sup> In addition to poison pills and staggered boards, US targets are also permitted other defenses, such as breakup fees and other “lockup” provisions that are designed to cement a deal with a favored bidder while keeping hostile bidders at bay.<sup>13</sup>

However, the discretion vested in target managers is not absolute. Managers are sometimes required to remove takeover defenses, as when the defenses tilt the playing field toward one bidder in the heat of an actively contested takeover battle. But target bidders have extensive discretion— particularly if they wish to “just say no” to any bid to acquire the company.<sup>14</sup> Moreover, nearly every state has enacted antitakeover legislation that is designed to slow down unwanted takeovers.<sup>15</sup> Under Pennsylvania's antitakeover law, for instance, managers are

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<sup>12</sup> This point is made forcefully in Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885 (2002).

<sup>13</sup> See, e.g., David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lockups*, 90 NW. U.L. REV. 564 (1996); John Coates & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307 (2000).

<sup>14</sup> Although the Delaware Supreme Court has never explicitly endorsed the “just say no” approach, and there are hints that the Delaware Chancery Court may reject it, at least for target companies that have both a staggered board and a poison pill, target managers are seen as having broad discretion to defend against an unwanted takeover bid.

<sup>15</sup> The first generation of state antitakeover statutes was struck down in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), largely because they purported to govern any corporation doing business in the state. States' lawmakers subsequently revised their antitakeover statutes to apply only to companies incorporated in the state. The second generation statutes were upheld in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

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.<sup>16</sup>

In contrast to the US, UK takeover regulation has a strikingly shareholder-oriented cast.<sup>17</sup> The most startling difference comes in the context of takeover defenses. Unlike their US brethren, UK managers are not permitted to take any “frustrating action” without shareholder consent, once a takeover bid has materialized.<sup>18</sup> Poison pills are strictly forbidden, and so is 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 lockup provision with a favored bidder.<sup>19</sup>

To be sure, the “no frustrating action” principle of the UK’s Takeover Code only becomes relevant when a bid is on the horizon. It might be thought that managers seeking to entrench themselves would take advantage of this less stringent *ex ante* regulation to “embed” takeover defenses well before any bid comes to light.<sup>20</sup> Such “embedded defenses” could range from the fairly transparent, such as the issuance of dual class voting stock, adopting a staggered board appointment procedure, or the use of “golden shares” or generous golden parachute provisions for managers, to the more deeply embedded, such as provisions in bond issues or licensing agreements that provide for acceleration or termination if there is a change of control.

Yet in UK practice, embedded defenses are not observed on anything like the scale that they are used in the US. This is partly because of various other aspects

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<sup>16</sup> Under a fair price provision, a bidder who acquires less than 100% of the stock and wishes to eliminate minority shareholders through a cash out merger after acquiring control is required to pay as much to the minority shareholders as in the original acquisition.

<sup>17</sup> On the UK regulation, *see generally* THE PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS (THE “TAKEOVER CODE”) (2006), available at <http://www.thetakeoverpanel.org.uk/new/codesars/DATA/code.pdf>; WILLIAM UNDERHILL (ED.), WEINBERG AND BLANK ON TAKE-OVERS AND MERGERS (5<sup>th</sup> ed., 1989, supp. 2006) (“WEINBERG & BLANK”); GARY EABORN (ED.), TAKEOVERS: LAW AND PRACTICE (2005) (“EABORN”).

<sup>18</sup> TAKEOVER CODE, General Principle 7 and Rule 21.

<sup>19</sup> *See* WEINBERG & BLANK, ¶¶ 4-7038, 4-7092 to 4-7130B; EABORN at 394-96, 419-20, 436-37.

<sup>20</sup> This strategy is discussed in Richard E. Kihlstrom & Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law*, 152 U. PA. L. REV. 523 (2003); Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003).

of the UK's corporate governance environment, which restrict directors' ability to entrench themselves. For example, English company law requires directors to seek approval from the general meeting for authority to issue new shares,<sup>21</sup> and in listed companies this will usually only be granted subject to guidelines formalized by institutional investors.<sup>22</sup> Dual class voting stock, though not directly prohibited, is strongly frowned upon by institutional investors,<sup>23</sup> and a company that seeks to issue it will suffer a severe price penalty in raising capital.<sup>24</sup> In addition, pre-emption rules provide that directors must offer any new shares first to existing shareholders *pro rata* with their holdings.<sup>25</sup> The force of staggered board mechanisms is destroyed by a mandatory rule that shareholders may remove directors at any time by ordinary resolution,<sup>26</sup> and a combination of provisions limit the extent to which "golden parachute" provisions in executive service contracts can entrench managers.<sup>27</sup>

As in the US, UK bidders are subject to an equal treatment rule that requires them to pay the same price to all shareholders wishing to accept a tender offer.<sup>28</sup>

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<sup>21</sup> Companies Act 1985 s 80.

<sup>22</sup> See ASSOCIATION OF BRITISH INSURERS, GUIDANCE ON DIRECTORS' POWERS TO ALLOT SHARE CAPITAL AND DISAPPLY SHAREHOLDERS' PRE-EMPTION RIGHTS (1995).

<sup>23</sup> G.P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE (1996) at 58-59; WEINBERG & BLANK at ¶ 4-7077 (noting rarity of dual-class issues and a number of instances where proposals to issue dual-class shares have been dropped following hostility from institutional investors).

<sup>24</sup> For example, non-voting shares typically trade at a discount of 10-20%: WEINBERG & BLANK at ¶ 4-7073.

<sup>25</sup> UK Listing Rules, rr. 4.16-4.21; Companies Act 1985 ss. 89-96. The pre-emption rights regime may be relaxed with shareholder approval, but institutional investor guidelines provide that this will only be granted in limited circumstances: ASSOCIATION OF BRITISH INSURERS, PRE-EMPTION GROUP GUIDELINES (1987).

<sup>26</sup> Companies Act 1985 s 303.

<sup>27</sup> See Companies Act 1985, ss 234A, 241A and Sch 7A, introduced by Directors' Remuneration Report Regulations 2002 (requiring annual publication by listed companies of detailed report on directors' remuneration and precatory vote by general meeting on its contents); UK LISTING AUTHORITY, THE COMBINED CODE ON CORPORATE GOVERNANCE (2003) ("COMBINED CODE"), available at [http://www.fsa.gov.uk/pubs/ukla/lr\\_comcode2003.pdf](http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf), at ¶ B.1.7 (notice period of directors' service contracts should usually be no more than one year).

<sup>28</sup> It is a fundamental principle that bidders must treat all shareholders of the same class of a target company similarly (TAKEOVER CODE, General Principle 1); this is supplemented by a number of specific rules, including requirements that the offer price match the best price paid by the bidder for the target's shares during the three months before the offer (*id.*, Rule 6), that comparable offers must be made with all classes of equity share capital (*id.*, Rule 14) and that no "special deals with favourable conditions" be made with any shareholders (*id.*, Rule 16).

However, the UK rules go considerably further in promoting equal treatment of target shareholders, so as even to require that anyone purchasing what amounts to a controlling stake (deemed to occur on acquisition of 30% or more of the voting rights in the target's share capital)<sup>29</sup> must compulsorily make an offer (known as a "mandatory bid") for the remainder of the target's share capital.<sup>30</sup> To be sure, this provision, which is intended to protect minorities by ensuring that all shareholders get the opportunity to share in the payment of a control premium,<sup>31</sup> is not unequivocally pro-shareholder.<sup>32</sup> This is because, by restricting the permitted range of partial bids,<sup>33</sup> the mandatory bid rule chills some potential offers by forcing bidders to raise enough money to acquire the entire company, rather than just a controlling stake. However, this cost is likely to be at least matched by the benefit of guaranteed participation any offer that is made.

The overall picture emerging, especially from the differences in the treatment of defensive tactics, is that US takeover regulation seems significantly less shareholder-oriented than its UK counterpart. As the authors of *The Anatomy of Corporate Law*, a prominent recent book on comparative corporate law, put it, "[d]espite the commonality of the issue, the UK and the US have made almost diametrically opposed choices" on how to regulate hostile takeovers.<sup>34</sup>

## B) So What? (Do the Differences in the Substance of Takeover Regulation Matter?)

What, though, should we make of these substantive differences? Is one approach superior to the other, or are the differences unimportant in the overall scheme of things?

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<sup>29</sup> TAKEOVER CODE, Section C ("Definitions") (defining "control" as "a holding, or aggregate holdings, of shares carrying 30% or more of the voting rights ... of a company, irrespective of whether the holding or holdings gives de facto control.")

<sup>30</sup> TAKEOVER CODE, Rule 9.

<sup>31</sup> See EABORN at 132-33.

<sup>32</sup> See D.D. Prentice, *Take-over Bids and the System of Self-Regulation*, 1 OX. J. LEG. STUD. 406, 409 (1981); Erik Berglöf & Mike Burkart, *European Takeover Regulation*, 18 ECON. POLICY 171, 196-198 (2003).

<sup>33</sup> A partial bid in the UK requires the consent of the Takeover Panel (TAKEOVER CODE, Rule 36.1), although this will usually be granted if the bid would not result in the acquisition of more than 30% of the target's voting rights—that is, it would not infringe the mandatory bid rule (see EABORN at 56).

<sup>34</sup> REINIER KRAAKMAN ET AL, *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 164 (2004).

Table 1: M&A hostility in the US and UK: 1990-2005<sup>35</sup>

	(1)	(2)	(3)	(4)	(5)
Location of target	All M&A announced	Hostile		Hostile, completed	
	#	#	% of (1)	#	% of (2)
US	54,849	312	0.57	75	24
UK	22,014	187	0.85	81	43

Source: Thomson *SDC Platinum* database

The UK's ban on defensive tactics by managers clearly makes it easier for hostile bids to succeed. Indeed, as Table 1 shows, an M&A transaction in the UK is more likely to be hostile, and if hostile, is more likely to succeed, in the UK than in the US. In both countries, hostility is the exception, rather than the rule, but in the UK, 0.85% of takeovers announced during the period 1990-2005 were hostile, compared with 0.57% in the US. Of these hostile bids, 43% were successful in the UK, as opposed to just 24% in the US. Evidence for a link between takeover defenses and takeover practice is buttressed by the fact that the rise of antitakeover mechanisms such as "poison pills" by US firms in the 1990s coincided with a dramatic decline in levels of hostility in takeovers from the 1980s.<sup>36</sup> Those who view hostile takeovers as a disciplinary mechanism for managers therefore tend to prefer a regime like Takeover Code that does not permit managers to use defensive tactics.<sup>37</sup> This gives boards a greater incentive to focus on returns to shareholders.

Takeovers are, of course, executed for a variety of reasons, of which the removal of underperforming managers is just one.<sup>38</sup> While some of these other reasons

<sup>35</sup> Table 1 reports figures on M&A activity from 1990 to 2005 (inclusive) taken from Thomson *SDC Platinum*. Column (1) shows the total number of M&A transactions announced during this period for which the target was located in the US and UK, respectively. Columns (2) and (3) show the number, and percentage, respectively, of these transactions which were hostile. Column (4) shows the number of hostile transactions that were completed, and column (5) shows this as a percentage of the number of hostile transactions.

<sup>36</sup> See Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 127 (2001); Omesh Kini, William Kracaw & Shehzad Mian, *The Nature of Discipline by Corporate Takeovers*, 59 J. FIN. 1511, 1515 (2004).

<sup>37</sup> See, e.g., Ronald J. Gilson, *Unocal Fifteen Year Later (and what we can do about it)*, 26 DEL. J. CORP. L. 491 (2001); Ronald J. Gilson & Alan Schwartz, *Sales and Elections as Methods for Transferring Corporate Control*, 2 THEORETICAL INQUIRIES L. 783 (2001); Lucian Ayre Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).

<sup>38</sup> For a classic survey, see Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 YALE J. ON REG. 119, 125-155 (1992).

will tend to enhance social welfare—for example, the desire to exploit synergies through combination with the target firm—others are less benign. Some argue that many takeovers create wealth for stockholders only at the expense of other constituencies: most saliently, creditors and employees.<sup>39</sup> Takeovers may on occasion also be driven by “empire-building” by bidder managers, which would be unlikely to result in the creation of value for their shareholders.<sup>40</sup> If purely redistributive or value-decreasing motives predominate, then it may be desirable to restrict takeover activity.<sup>41</sup>

However, the empirical evidence on takeovers suggests that they generally create value. Empirical studies have consistently found that target shareholders experience significant positive returns from a takeover event.<sup>42</sup> In contrast, the empirical findings are more varied with respect to bidder shareholders: some studies report a small gain, others a small loss.<sup>43</sup> Yet even where losses accrue to

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<sup>39</sup> Creditors, for example, may find the face value of their claims suddenly deflated by the target’s having taken on a heavy debt burden to finance the acquisition or subsequent restructuring: see Morey McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986); William W. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, DUKE L.J. 92 (1989). Employees, who have made investments in firm-specific human capital on the faith of implicit promises of job security, may find themselves representing simply an operating cost to the bidder, and be given their walking papers: see Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (ALAN J. AUERBACH ED., 1988). In each case, a bid may be motivated by the desire to transfer wealth from these constituencies.

<sup>40</sup> See, e.g., Klaus Gugler, Dennis C. Mueller and B. Burçin Yurtoglu, *The Determinants of Merger Waves* (Working Paper, University of Vienna, 2004) (concluding that merger waves are driven primarily by overvaluation of bidder shares permitting them to be used to fund acquisitions, and/or bidder management empire-building).

<sup>41</sup> Takeovers might also be motivated by a desire to monopolize a market. Indeed, in the early 1900s, this was the predominant reason for mergers in the US, at a time when antitrust law stigmatized cartels but not mergers. However, in the presence of neutral antitrust regimes, such as those now existing on both sides of the Atlantic, concerns about competition need not form part of the debate about company law.

<sup>42</sup> See, e.g., in the US, Michael C. Jensen & Richard Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 10 (1983) (summarizing 7 previous studies over period 1958-81; 29.1% abnormal return to target shareholders); Gregg A. Jarrell & Annette B. Poulson, *The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades*, 18:3 FIN. MANAG. 12, 16 (1989) (1963-86: 28.9%); Gregor Andrade, Mark Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers*, 15:2 J. ECON. PERSP. 103, 110 (2001) (1973-98: 23.3%); in the UK, Julian R. Franks & Robert S. Harris, *Shareholder Wealth Effects of Corporate Takeovers: The U.K. Experience 1955-1985*, 23 J. FIN. ECON. 225, 232-3 (1989) (1955-85: 25.8%); Robin J. Limmack, *Corporate Mergers and Shareholder Wealth Effects*, 21 ACC’T & BUS. RES. 239, 245 (1991) (1977-86: 33.0%); Marc Goergen & Luc Renneboog, *Shareholder Wealth Effects of European Domestic and Cross-Border Takeover Bids*, 10 EUR. FIN. MANAG. 9, 23 (2004) (1993-2000: 29.3%) .

<sup>43</sup> See, e.g., in the US, Jensen & Ruback, *supra* note 42, 16 (1958-81: 3.8% abnormal return for bidders); Jarrell & Poulson, *supra* note 42, 16 (1963-86: 1.96%); Andrade *et al.*, *supra* note 42, 110

bidder shareholders, these are considerably smaller than the gains to target shareholders, suggesting that on average such transactions create a significant amount of net value for shareholders.<sup>44</sup> Two recent studies, the first of which focuses particularly on the effects of hostile takeovers in the UK,<sup>45</sup> and the second of which employs a new empirical methodology,<sup>46</sup> both find stronger evidence of positive returns to acquirer shareholders as well. Moreover, studies that have explicitly examined claims of expropriation have concluded that the gains to shareholders greatly outweigh any costs incurred by other constituencies.<sup>47</sup>

As the case for restricting takeover activity does not seem to be made out, our provisional conclusion is therefore that the UK's restrictions on defensive tactics seem preferable to the US approach. Yet one puzzling finding remains. While hostile bids are less likely to succeed in the US, the overall level of takeover activity, adjusted for the size of the economy, actually seems slightly higher than in the UK, even during the 1990s.<sup>48</sup> Might it be that, rather than deterring bidders altogether, the use of defensive measures in the US has simply resulted in a change of tactics? Because a target board's consent is necessary to effect a takeover where an effective defense is in place, US acquirers are now more likely to enter into negotiations with the target's board than to make a "hostile" offer direct to shareholders.<sup>49</sup>

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(1973-98: -3.8%); in the UK, Franks & Harris, *supra* note 42, 232-3 (1955-85: 2.4%); Limmack, *supra* note 42, 245 (1977-86: -2.6%); Goergen & Renneboog, *supra* note 42, 23 (1993-2000: -1.65%).

<sup>44</sup> Andrade *et al.*, *supra* note 42, at 103.

<sup>45</sup> Sudi Sudarsanam & Ashraf A. Mahate, *Are Friendly Acquisitions Too Bad for Shareholders and Managers? Long-Term Value Creation and Top Management Turnover in Hostile and Friendly Takeovers*, 17 BRIT. J. MANAG. S7, S17-S18 (2006) (sample of hostile and friendly UK acquisitions 1983-95: hostile acquirers have significantly better subsequent performance than friendly acquirers).

<sup>46</sup> Sanjai Bhagat, Ming Dong, David Hirshleifer & Robert Noah, *Do Tender Offers Create Value? New Methods and Evidence*, Working Paper, Fisher College of Business, Ohio State University (2004), 34-36 (1962-2001: concluding that bidders "on average pay fair prices for targets").

<sup>47</sup> See, e.g., Gregg A. Jarrell, James A. Brickley & Jeffrey M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2:1 J. ECON. PERSP. 49, 54-58 (1988).

<sup>48</sup> Based on data from the *SDC Platinum* database, in the period 1990-2002, 53.6% of firms listed in the UK were the target of a successful takeover, as compared with 65.6% in the US (Stefano Rossi & Paulo F. Volpin, *Cross-Country Determinants of Mergers and Acquisitions*, 74 J. FIN. ECON. 277, 281 (2004)).

<sup>49</sup> See G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder?*, 55 J. FIN. 2599 (2000) (finding that "friendly" and "hostile" takeovers in the US are economically indistinguishable, and concluding that the difference is merely a matter of negotiating tactic).



Whether this is a good thing rather depends upon the target board's incentives. If their interests are well-aligned with those of shareholders, then the target board can be expected to negotiate a better price for the shareholders.<sup>50</sup> Thus where the directors are subject to other governance mechanisms which encourage them to work in shareholders' interests—most notably, appropriately designed compensation packages giving them a strong interest in the company's share price, and a preponderance of non-executive directors as overseers of the executives' decisions, then the shareholders may be more confident that this *ex post* power will be exercised in accordance with their interests.<sup>51</sup>

Does this mean that US firms are able to “contract around” so as to achieve outcomes that are functionally equivalent to the UK?<sup>52</sup> For three reasons, we are skeptical of this claim.<sup>53</sup> First, 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.<sup>54</sup> A functional equivalence claim depends on the implausible assumption that managers, unconstrained by the threat of takeovers,

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<sup>50</sup> Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15:2 J. ECON. PERSP. 121, 132-137; Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 896-899 (2002); Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473, 484-489 (2003); cf. Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621 (2003) (empirical study finding no support for hypothesis that takeover defenses increase target bargaining power so as to promote higher price).

<sup>51</sup> See Thomas Moeller, *Let's Make a Deal! How Shareholder Control Impacts Merger Payoffs*, 76 J. FIN. ECON. 167, 186 (2005) (where a staggered board structure has been adopted, a significantly larger premium is obtained for target shareholders if the board is controlled by independent directors).

<sup>52</sup> The notion of “functional convergence” was popularized by Ron Gilson: see Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001).

<sup>53</sup> We are also skeptical as to recent suggestions in the literature that managers should be given discretion because information asymmetries or market inefficiencies make stock price a poor gauge of firm value (see Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 Nw. U. L. Rev. 521 (2002); Kihlstrom & Wachter, *supra* note 20). While the point is well taken that the presence of market inefficiencies casts doubt on strong prescriptions, we suspect that the benefits of managerial discretion are outweighed by managers' conflict of interest when a takeover bid is made.

<sup>54</sup> See Moeller, *supra* note 51 (where outside directors do not control board, significantly smaller takeover premium is achieved); see also Subramanian, *supra* note 50.

will nevertheless agree to other measures that will render them accountable to shareholders.<sup>55</sup>

Secondly, the negative impact for shareholders of protecting the board from takeovers is not only felt at the time of a bid, but manifests itself most strongly in weaker incentives for managers at times when no bid is on the horizon. Because managers can effectively veto a bid, they have little need to fear that underperformance will at some point be “disciplined” by the market. Consistently with this, empirical studies report that the adoption of an antitakeover law has a negative impact on the stock prices of firms incorporated in that jurisdiction.<sup>56</sup> Similarly, firms that adopt effective antitakeover devices appear to produce inferior returns for shareholders.<sup>57</sup>

Finally, “incentivizing” the board with equity-based compensation, the principal alternative to direct shareholder choice, is no panacea; this can have perverse effects as well as beneficial ones.<sup>58</sup> The 1990s saw a staggering growth in the options-based pay granted to top US executives, at a pace that was internationally unique. This has been widely implicated in the “culture of greed” that led to the downfall of Enron, Worldcom and other leading corporations.<sup>59</sup> As became clear with the US corporate scandals, heavily options-based pay gives managers an incentive to drive up the company’s stock price in any way possible, since managers profit if the price rises but aren’t punished if it falls.<sup>60</sup>

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<sup>55</sup> Interestingly, one study shows that the introduction of state antitakeover laws in the late 1980s was associated with a *reduction* in the proportion of equity owned by managers incorporated in those jurisdictions: the opposite direction of change to that implied by functional equivalence: Shijun Cheng, *Identifying Control Motives in Managerial Ownership: Evidence from Antitakeover Legislation*, 18 REV. FIN. STUD. 637 (2005).

<sup>56</sup> Laurence Schumann, *State Regulation of Takeovers and Shareholder Wealth: The Case of New York’s 1985 Takeover Statutes*, 19 RAND J. ECON. 557 (1988) (introduction of antitakeover statutes in New York in the mid-1980s reduced the market value of firms incorporated in that jurisdiction).

<sup>57</sup> See Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107 (2003); Lucian Bebchuk, Alma Cohen & Alan Ferrell, *What Matters in Corporate Governance?*, Working Paper, Harvard University (2005) (adoption of takeover defenses linked to inferior share price performance).

<sup>58</sup> See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

<sup>59</sup> See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002); JOHN C. COFFEE, JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* (2006), 62-64; DAVID SKEEL, *ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM* 152-54 (2005).

<sup>60</sup> See, e.g., SKEEL, *supra* note 59, at 154 (describing the effect of options); Kees Cools, *Ebbers Rex*, WALL ST. J., March 22, 2005, at B2 (reporting empirical results suggesting that the best predictors of

To summarize, then: in our view, the UK system renders managers more directly accountable to shareholders. While it is possible for US firms to contract around its more manager-friendly regime, the costs of doing so seem to be very high. Thus the differences in the substance of takeover regulation seem to lead to real differences in takeover practice.

### C) The Divergent Modes of Regulation

Shifting now to the mode of takeover regulation, we find differences that are even more striking than those relating to the substance of the two nations' rules. Once again, we begin with the US.

US takeover regulation is the domain of courts and regulators. The tender offer itself is regulated principally by the Securities and Exchange Commission, which assesses compliance with the disclosure and process rules. Managers' response to a takeover bid, by contrast, is regulated primarily by state courts— which usually means Delaware's Chancery judges and Supreme Court. When a takeover bidder believes that the target's managers are improperly stymieing its bid, the bidder generally files suit in the Delaware Chancery Court. The suit argues that the target managers have breached their fiduciary duties— that the managers' resistance is beyond the pale— and that the managers should be forced to remove their defenses so that the takeover can be considered by the target's shareholders.<sup>61</sup>

The key players in the drama are lawyers and judges. Each of the relevant parties is advised by lawyers, and contested takeover battles nearly always make their way to the courts. In Delaware, the nation's most sophisticated and efficient corporate law arbiter, this may mean a week or two, and sometimes substantially longer, in the Chancery Court. The battle by Oracle to take over PeopleSoft, to give just one example, required a trial that unfolded over a period of several weeks, while the parties bargained— as Vice Chancellor Leo Strine has put it, with a bit of exaggeration about his own appearance— “in the glare of the vice chancellor's bald head.”<sup>62</sup> The PeopleSoft battle finally ended when PeopleSoft's managers agreed to the takeover, which obviated the need for either a written opinion or an appeal to the Delaware Supreme Court. But many of the most hotly contested takeover issues are finally resolved after another

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the likelihood a company would become involved in a corporate scandal were extent of options based compensation and earnings targets).

<sup>61</sup> Once the bidder files suit, other target shareholders often file “piggyback” litigation. The Delaware courts usually address the various suits together.

<sup>62</sup> Personal conversation with one of the authors.

round of lawyers' arguments in the Supreme Court.

Turn to the UK and the lawyers miraculously disappear.<sup>63</sup> When a hostile bidder launches a takeover effort and believes that the target's managers are interfering with the bid, the bidder lodges a protest with the Takeover Panel. Originally housed in the Bank of England, the Takeover Panel is now located in the London Stock Exchange building. The Takeover Panel—which includes representatives from the Stock Exchange, the Bank of England, the major merchant banks, and institutional investors—administers a set of rules known as the City Code on Takeovers and Mergers.<sup>64</sup> Both the Panel and the Code were, until very recently, entirely self-regulatory. Although, as part of the UK's implementation of the EU's Takeover Directive, they have now been given a statutory underpinning, this has been designed with the express objective of maintaining the characteristic features of the Panel's approach, which are based on self-regulation.

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.<sup>65</sup> 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 overall process usually takes weeks and

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<sup>63</sup> See generally Lord Alexander of Weedon, *Takeovers: The Regulatory Scene*, J. BUS. L. 203 (1990); Takis Tridimis, *Self-Regulation and Investor Protection in the United Kingdom: The Takeover Panel and the Market for Corporate Control*, 10 CIV. JUST. Q. 24 (1991); T. Peter Lee, *Takeover Regulation in the United Kingdom*, in EUROPEAN TAKEOVERS: LAW AND PRACTICE 133 (KLAUS HOPT & EDDY WYMEERSCH EDS., 1992); Geoffrey K. Morse, *Controlling Takeovers—The Self Regulation Option in the United Kingdom*, J. BUS. L. 58 (1998); Edward Baker & Selina Sagayam, *The UK Takeover Regime—The Way it Works, Why it Works and What Lies Ahead Under the Takeover Directive*, 10 ONDERNEMINGSRECHT 384 (2004).

<sup>64</sup> See generally sources cited *supra* note 17. Since 20 May 2006, both the Takeover Panel and the City Code have been given a legal underpinning, as part of the UK's implementation of the EU's Takeover Directive (discussed *infra*, text to notes 275-285). However, the implementation has been with carried out the express objective of maintaining all the characteristic features of the Panel's functions discussed in the text. Hence the Code retains most of the characteristics of "soft law", even if this description is technically now outdated.

<sup>65</sup> A party unhappy with a ruling from the Panel's Executive could appeal to the Panel's Hearings Committee.

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.”<sup>66</sup>

Secondly, the flexibility of the Panel’s approach means that it is able to adjust its regulatory responses both to the particular parties before it, and to the changing dynamics of business within the City of London. Takeover participants are expected to comply with the “spirit” as well as the letter of the Code, on which they are expected to seek guidance from the Panel. Because they are actively engaged with the parties, the Panel’s Executive are able to tailor the regulatory requirements (outlining compliance conditions or waiving rules, as appropriate) to the circumstances of a particular case. Moreover, the Panel’s Code Committee is charged with regular and pro-active updating of the Code’s provisions to reflect changes in the market place.

Finally, as already noted, lawyers play relatively little role in Takeover Panel oversight. The Panel’s members come from the principal shareholder and financial groups, and the staff consists primarily of business and financial experts, rather than lawyers, due to a conscious decision from the beginning “that the Panel executive should for the most part be staffed by temporary secondments from City firms.”<sup>67</sup> The Takeover Panel is thus business-oriented, rather than legal. The culture could hardly be more different than the lawyers-with-briefcases approach that characterizes American takeover regulation.

#### D) So What? (Again): Do the Differences in the *Mode* of Takeover Regulation Matter?

With the substantive differences between the US and UK approaches, we were somewhat agnostic as to whether one approach is preferable to the other. With the mode, or process, we have far less ambivalence: we consider that the UK’s system has clear advantages.

Consider first speed. The Takeover Code prescribes a clear timetable for the conduct of bids, in order to minimize the amount of time for which the

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<sup>66</sup> SIR ALEXANDER JOHNSTON, *THE CITY TAKE-OVER CODE*, at 125 (1980).

<sup>67</sup> *Id.* at 127.

uncertainty of a takeover battle may surround the target company.<sup>68</sup> This is reflected both in the Code itself and in the Panel's practice throughout the bidding process. Thus a bidder that has expressed a firm intention to make an offer must usually follow this with a formal offer within 28 days.<sup>69</sup> A formal offer, once made, may not usually remain open for more than 60 days unless it has been declared unconditional as to acceptances,<sup>70</sup> and all other conditions must be fulfilled within 21 days from that point.<sup>71</sup> Moreover, an unsuccessful bidder may not normally make another offer for the same target within 12 months.<sup>72</sup>

Consistently with this goal of resolving bidding situations quickly and with minimum uncertainty, tactical litigation is usually ruled out. The Panel will normally prohibit the target board from commencing legal action without which might have the effect of frustrating a bid, regardless of the perceived merits of the claim in question, unless shareholder consent has been obtained.<sup>73</sup> The

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<sup>68</sup> TAKEOVER CODE, Rules 30-35. Deviations from the timetable may be permitted by the Takeover Panel in particular cases.

<sup>69</sup> *Id.*, Rule 30.1. If a party announces that it is considering making a bid, the potential target may ask the Panel to issue a so-called “put up or shut up” notice to the potential bidder to resolve the uncertainty—that is, to clarify publicly whether it will be making a bid: *id.*, Rule 2.4(b); *see also The Takeover Panel, Code Committee Consultation Paper: “Put Up or Shut Up” and No Intention to Bid Statements*, PCP 2004/1 (2004) (available at <http://www.thetakeoverpanel.org.uk/new/consultation/DATA/PCP200401.pdf>).

<sup>70</sup> TAKEOVER CODE, Rule 31.6. The announcement of a second bid will reset the timetable for the first bidder in order to give it time to respond by raising its price. However, where a competitive bidding situation has not been resolved within 46 days of the second offer, the parties must move to an accelerated open auction procedure: *Id.*, Rule 32.5. *See also The Takeover Panel, Code Committee Consultation Paper: Resolution of Competitive Situations*, PCP7 (2001) (available at <http://www.thetakeoverpanel.org.uk/new/consultation/DATA/PCP7.pdf>).

<sup>71</sup> TAKEOVER CODE, Rule 31.7.

<sup>72</sup> *Id.*, Rule 35.1.

<sup>73</sup> TAKEOVER PANEL, PANEL STATEMENT 1989/7 (CONSOLIDATED GOLD FIELDS PLC) (available at <http://www.thetakeoverpanel.org.uk/new/statements/DATA/1989/1989-07.pdf>); WEINBERG & BLANK, ¶¶ 4-7114 to 4-7130B. In deference to the overriding public importance perceived to attach to antitrust concerns, a more lenient approach is taken as regards references to competition authorities by the target. An initial reference, at least, would be unlikely to be considered to breach the Code (*see* TAKEOVER PANEL, PANEL STATEMENT 1989/20 (B.A.T. INDUSTRIES PLC), available at <http://www.thetakeoverpanel.org.uk/new/statements/DATA/1989/1989-20.pdf>, at 11). Bidders have responded to the risk that his poses to offers by seeking clearance, where antitrust concerns are material, in advance of making a firm offer. If clearance is given, then a tactical appeal by the target against the competition authority's decision would be likely to be viewed as “frustrating action” by the Panel (*see* EABORN at 679-80).

Panel's decisions have themselves been held to be subject to judicial review.<sup>74</sup> However, the English Court of Appeal, concerned not to allow judicial review to become a tactic for interfering with the Panel's "real-time" decision making, made clear that relief, if ever granted, would only be declaratory regarding future conduct and would not have any consequences for the validity of decisions which have been taken.<sup>75</sup>

In the US, there are no such restrictions on how long an offer may remain open, or indeed on repeated bids for the same target. Furthermore, resort to litigation is a defensive tactic frequently employed by target boards. When Oracle launched its highly publicized bid for PeopleSoft in 2003, for instance, PeopleSoft's first response was to sue, accusing Oracle of "deceptive business practices, tortious interference, and a litany of other misdeeds."<sup>76</sup> PeopleSoft then began an intense, successful campaign to persuade the U.S. Department of Justice to challenge the proposed acquisition on antitrust grounds.<sup>77</sup> Only eighteen months later, after the government's antitrust challenge had been rejected, did Oracle finally prevail.<sup>78</sup> In part because of target managers' ability to use defenses and stalling tactics, a typical M&A deal in the US takes approximately five months to complete,<sup>79</sup> and the period is usually considerably longer for hostile acquisitions.<sup>80</sup>

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<sup>74</sup> *R. v. Panel on Takeovers and Mergers, ex parte Datafin plc* [1987] QB 815.

<sup>75</sup> *Id.* at 841-42.

<sup>76</sup> David Millstone & Guhan Subramanian, *Oracle v. PeopleSoft: A Case Study*, 7 (Sept. 2005), available at SSRN.Com.

<sup>77</sup> The campaign is described in *id.* at 11.

<sup>78</sup> See, e.g., *id.* at 20. PeopleSoft finally gave in at the end of a multi-week trial in the Delaware Chancery Court to address Oracle's claims that the PeopleSoft directors' defensive tactics violated their fiduciary duties. For a colorful diary of the trial, see David Marcus, *The Trial: A Journal of Two Weeks in Delaware with Leo Strine, Larry Ellison, Craig Conway and Lots of Arbs on Cell Phones*, THE DEAL, Nov. 1, 2004, at 14. For a defense of PeopleSoft's post-bid defensive tactics, arguing that the PeopleSoft directors preserved the viability of the company, see Jennifer Arlen, *Regulating Post-Bid Embedded Defenses: Lessons from Oracle Versus PeopleSoft* (unpublished manuscript, August 2006), available at <http://ssrn.com/abstract=921833>.

<sup>79</sup> See David A. Becher & Jennifer L. Juergens, *Influencing Merger Outcomes: The Role of Investment Analysts in Merger Success*, Working Paper, Drexel University/Arizona State University, October 2004 at 27 (Table 1: average time to completion for sample of US M&A deals during period 1993-2000 was 146 days).

<sup>80</sup> William C. Hunter & Julapa Jagtiani, *An Analysis of Advisor Choice, Fees, and Efforts in Mergers and Acquisitions*, 12 J. FIN. ECON. 65 at 74-76 (2003) (reporting results for sample of M&A deals during 1995-2000: hostile tender offers typically take longer to complete than friendly deals).

Now consider costs. Litigation is an expensive way of resolving disputes. Table 2 shows that approximately one-third of hostile takeovers in the US are litigated. In contrast, hostile bids are almost never litigated in the UK, where a significant proportion of the regulatory issues are resolved by no more than a telephone call to the Panel Executive. In contrast to the services of litigation lawyers, the Panel does not charge for the issuance of such guidance. Rather, its operations are funded by a fee charged in relation to formal offers,<sup>81</sup> a small levy paid on significant dealings in shares on the London Stock Exchange,<sup>82</sup> and by sales of the Takeover Code.<sup>83</sup>

Table 2: M&A litigation in the US and UK: 1990-2005<sup>84</sup>

	(1)	(2)	(3)
Location of target	Hostile	Hostile, litigated	
	#	#	%
US	312	106	33.9%
UK	187	2	0.1%

Source: Thomson *SDC Platinum* database

Given the differences in litigation rates, we would expect US lawyers to make more money from M&A transactions than their UK counterparts. Whilst lawyers in both jurisdictions would advise on the transactions themselves, US lawyers also advise on takeover litigation, which simply does not occur in the UK. To our knowledge, no direct evidence currently exists on the comparative level of legal advisor fees incurred in the two jurisdictions.<sup>85</sup> However, as Table 3

<sup>81</sup> A “document charge” is levied by the Panel on the issue of formal offer documentation in relation to offers exceeding £1m in value. It is set at a declining marginal rate, starting at 0.2% of the value of an offer over £1m, and falling to below 0.02% of the value of offers over £1bn (TAKEOVER CODE, APPENDIX, “DOCUMENT CHARGES”).

<sup>82</sup> The levy is £1 on any purchase or sale of shares in excess of £10,000 (LONDON STOCK EXCHANGE, PANEL ON TAKEOVERS AND MERGERS—PTM LEVY, STOCK EXCHANGE NOTICE N07/02, 7 March 2002).

<sup>83</sup> See, e.g., TAKEOVER PANEL, REPORT AND ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2005 at 16 (2006).

<sup>84</sup> Table 2 reports figures on M&A litigation from 1990 to 2005 (inclusive) taken from Thomson *SDC Platinum* database. Column (1) shows the total number of hostile M&A transactions announced during this period for which the target was located in the US and UK, respectively. Columns (2) and (3) show the number, and percentage, respectively, of these transactions for which “litigation” or “litigation delay” is recorded as an aspect of the deal.

<sup>85</sup> None of the major M&A databases (Mergermarket, Bloomberg and Thomson *SDC Platinum*) contain records of legal advisor fees for a meaningful number of transactions.



shows, leading US firms with an M&A oriented practice generate significantly more revenue per lawyer and profit per partner than do their UK counterparts. While of course law firms' financial performances are affected by a wide range of factors, these figures are not inconsistent with the conclusion that the US system is considerably more expensive for parties to a takeover.<sup>86</sup> Diversified shareholders, who stand to participate equally on the winning and losing sides of transactions would, however, surely prefer a cheaper system of regulating takeovers.

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<sup>86</sup> In a litigation-oriented system, lawyers may be expected to generate greater fees not only in cases that are actually litigated, but in any case where litigation is a threat.

Table 3: Financial performance of leading M&A law firms, 2004-5<sup>87</sup>

US Firms	Profits per equity partner/ \$k	Revenue per lawyer/ \$k	UK Firms	Profits per equity partner/ \$k	Revenue per lawyer/ \$k
Wachtell, Lipton	3,790	2,395	Slaughter and May	1,985	953
Sullivan & Cromwell	2,410	1,625	Linklaters	1,593	756
Cravath	2,600	1,280	Freshfields	1,323	697
Davis Polk	2,000	1,145	Clifford Chance	1,230	697
Simpson Thacher	2,370	1,125	Herbert Smith	1,527	627

Sources: *AmLaw 100* (www.americanlawyer.com); *The Lawyer Global 100* (www.thelawyer.com)

The differences between the two systems extend beyond the resolution of individual takeover situations. Perhaps even more significant are the dynamic effects—that is, the way in which the two regulatory regimes change over time. The UK’s regulatory regime is proactive in its response to market developments. The Code Committee of the Takeover Panel meets several times a year to discuss the operation of the market, assess recent developments and determine whether any amendments to the Takeover Code are necessary in response.<sup>88</sup> In contrast, US courts make rules in a way that is essentially reactive: changes in the marketplace lead to litigation, following which, the courts pronounce upon acceptable behavior.

The Delaware courts have adapted the traditional litigation process to counteract its limitations in several important respects. First, Delaware’s generosity in awarding attorney’s fees to the lawyers for shareholder plaintiffs assures a steady stream of cases to the Delaware courts. Moreover, even when it concludes that the directors did not breach their duties, the chancery court often critiques the directors’ performance, offering guidance to directors who will be dealing with similar issues in the future.<sup>89</sup> Finally, the five Delaware Chancery

<sup>87</sup> Exchange rate used: GB£1.00 = US\$1.89 (www.ft.com, August 30, 2006).

<sup>88</sup> For example, the Code Committee met seven times in 2005-6 (THE TAKEOVER PANEL, REPORT AND ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006 (2006), available at <http://www.thetakeoverpanel.org.uk/new/reports/DATA/Report2006.pdf>, at 11) and eight times in 2004-5 (THE TAKEOVER PANEL, REPORT AND ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2005 (2005), available at <http://www.thetakeoverpanel.org.uk/new/reports/DATA/Report2005.pdf>, at 10).

<sup>89</sup> These attributes of the Delaware courts are explored in detail in Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

judges frequently compare notes, often over lunch, about emerging corporate law issues, which enables them to begin mulling over new developments long before a particular dispute arises. Despite these remarkable adaptations, however, it remains true that the Delaware courts cannot take action until an actual controversy arises.

An issue that has recently led to controversy in takeover disputes on both sides of the Atlantic provides a simple case study of the process differences we have just described. In a number of recent takeover disputes, bidders have sought to acquire or influence control of a target without triggering disclosure obligations by using derivatives. A good example are “contracts for differences” or “CFDs” (known as “equity swaps” in the US), bilateral contracts under which the holder essentially takes a bet against a financial institution counterparty on the price of an underlying security. As part of its hedging strategy for a long CFD,<sup>90</sup> the counterparty will typically acquire the underlying security, which can then be transferred to the purchaser in settlement of a long position. Because it is fully hedged, the counterparty has no financial interest in the underlying security, but nevertheless holds the voting rights, which it may be persuaded to exercise in accordance with the wishes of the CFD holder.<sup>91</sup> Through this arrangement, the CFD holder may be in a position to exercise voting control of the underlying shares without having any beneficial interest in them. Such arrangements were in several recent instances used to assist bidders in acquiring control of targets without triggering disclosure obligations.<sup>92</sup>

In the US, a similar strategy achieved notoriety in 2005 in connection with a proposed acquisition by Mylan, a pharmaceutical company, of King, another pharmaceutical. Perry Corp., a hedge fund that held a substantial stake in King, bought and simultaneously hedged 9.9% of Mylan’s stock.<sup>93</sup> In effect, Perry

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<sup>90</sup> For a long CFD, the holder bets on a rise in price of the underlying security; for a short CFD, on a fall.

<sup>91</sup> See TAKEOVER PANEL, DEALINGS IN DERIVATIVES AND OPTIONS: OUTLINE PROPOSALS, PCP 2005/1 at 4-5 (2005).

<sup>92</sup> For example, when BAe Systems plc made an offer for Alvis plc in 2004, BAe was able to obtain irrevocable commitments to accept its offer in respect of 16% of Alvis’ share capital, through obtaining promises from counterparties to long CFDs it had entered into in respect of Alvis’ shares (*id.* at 6).

<sup>93</sup> The Perry episode is described and criticized in David Skeel, *Behind the Hedge*, LEG. AFFAIRS, Nov/Dec 2005, at 28, 29-30 (emphasizing that Perry’s economic incentives were diametrically opposed to the interests of other Mylan shareholders—the more overpriced the acquisition, the more Perry would have profited due to its stake in King). For thoughtful and extensive analysis of the new vote buying techniques, see Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and Decoupling of Economic and Voting Ownership in Public Companies* (unpublished manuscript, Jan. 6, 2006); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*

bought 9.9% of the Mylan votes, in an effort to tip the Mylan vote in favor of the acquisition so that it could profit from acquisition of its King shares. Perry's gambit (later abandoned after Carl Icahn, another Mylan stockholder, sued) brought the new vote buying technique and the potential for abuse to public attention.

The Takeover Panel's response to similar issues in the UK was, after consultation in 2005, to amend the Takeover Code in May 2006 so as to equalize the disclosure treatment of long CFDs and similar derivative contracts with that of the underlying securities.<sup>94</sup> In the US, by contrast, the response has been much slower. There are hints of activity at the SEC, but it probably lacks authority, without a Congressional amendment to the securities laws, to promulgate a substantive rule aimed at the new vote buying.<sup>95</sup> Nor is there any evidence that Delaware will intervene anytime soon.<sup>96</sup>

In summary, the US approach gives target managers discretion to defend a bid, whereas the UK gives the decision to shareholders. The principal decision makers in the US are Congress and the Delaware courts. In the UK, by contrast, informal regulation by the Takeover Panel takes center stage. While neither approach is clearly superior substantively, the UK process seems quicker, cheaper, and more proactive in response to market developments.

### III. THE HISTORICAL DIVERGENCE: A BRIEF CHRONOLOGICAL TOUR

The deep divergences in US and UK takeover regulation are surprising on several different levels. After all, when it comes to business and finance, the US and the UK arguably have more in common than any other pair of developed economies. Corporate governance is market-oriented in each country, and the largest corporations are characterized by a separation of ownership and control

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(unpublished manuscript, July, 2006) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=919881](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=919881).

<sup>94</sup> See TAKEOVER PANEL, *supra* note 91; TAKEOVER PANEL, CONSOLIDATED AMENDMENTS TO THE TAKEOVER CODE EFFECTIVE ON 20 MAY 2006 (2006).

<sup>95</sup> The SEC could, however, use its existing authority to require more disclosure of derivatives based vote buying. For a proposed disclosure framework that would achieve this effect, see Hu & Black, *supra* note 93. Disclosure-based regulation seems likely to be the principal US regulatory response, but the SEC had not even begun the rulemaking process as of this writing.

<sup>96</sup> See, e.g., *id.* at 35 (noting that Perry's vote buying does appear to violate the Delaware prohibition against vote buying because Perry did not directly purchase votes).

that is uncommon elsewhere in the world. The legal system in each country has a common law orientation, unlike the civil law approach that characterizes many other countries. Yet, despite all of these similarities, the US and UK use very different strategies for regulating takeovers, the most prominent issue in all of corporate law.

Why did the two nations take such divergent courses? To answer this question, we must delve into the political and historical evolution of the two approaches.

#### A. What Happened in the US?

Although US takeover regulation is often associated with a cluster of Delaware takeover cases in the 1980s, the foundations were laid much earlier. For present purposes, the key events were a series of New Deal banking and securities law reforms in the 1930s. Their effects were reinforced three decades later, after the emergence of hostile tender offers, by Delaware's 1967 corporate law reforms and the Williams Act amendments to the securities laws passed by Congress the following year. These legislative developments foreclosed other regulatory options, leaving takeover regulation to the Delaware courts.

The 1933 and 1934 securities acts were passed in the wake of the 1929 Crash and the early years of the Depression, and sought to correct the perceived market abuses of the 1920s by imposing new disclosure and antifraud regulation.<sup>97</sup> The 1934 act also established the Securities and Exchange Commission to serve as the principal policeman of the markets. During this same period at the outset of Franklin D. Roosevelt's presidency, Congress also enacted major banking regulation that separated commercial and investment banking (the Glass-Steagall Act), and established deposit insurance to protect Americans' savings (Glass-Steagall, together with the Banking Act of 1935).<sup>98</sup>

With a strong populist wind at its back, the New Deal Congress quite explicitly sought to restructure American business and finance through these reforms. The banking reforms were designed to break the near monopoly that J.P. Morgan and

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<sup>97</sup> Like nearly all of America's most important federal corporate regulation, the securities acts were passed in the aftermath of major corporate scandals. For a historical analysis of the enactment of the securities laws, together with the New Deal restructuring of the banking and utilities industries briefly described below, see, e.g., SKEEL, *supra* note 59, at 75-106.

<sup>98</sup> The Glass-Steagall Act of 1933, which separated commercial and investment banking, lasted until 1999, when it was largely repealed. Glass-Steagall Act of 1933, ch. 89, 48 Stat. 162 (codified at 12 U.S.C. § 377), *repealed* by Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341.

a small group of other banks had on American corporate finance, and to sharply diminish the banks' role in the governance of America's largest corporations. The creation of the SEC, and the SEC's authority to oversee the stock exchanges, then put a governmental regulator in the oversight role that had previously been occupied by the banks and other Wall Street insiders. Many of Roosevelt's corporate law advisors wanted to go still further, and enact a federal incorporation statute that would make Congress rather than the states the principal regulator of corporate law.<sup>99</sup> But the campaign for federal incorporation foundered, in part because of missteps in the timing and framing of the legislation.<sup>100</sup>

Takeovers didn't enter the picture in any significant way for another twenty years. The first hint of a change came in 1954, when Robert Young launched a hotly contested and ultimately successful proxy contest for control of the New York Central Railroad. The Young proxy contest was viewed as an assault on existing norms of Wall Street behavior, which discouraged public challenges to corporate directors.<sup>101</sup> Although Young's campaign was a spectacular success, and the 1950s also saw several other prominent battles,<sup>102</sup> proxy contests were an unwieldy and usually ineffective mechanism for obtaining control, since the success depended on the bidder's powers of persuasion and the extent of dissatisfaction among the company's shareholders. In the late 1950s and early 1960s, corporate raiders devised a more powerful strategy, the tender offer. Tender offers were far more effective than the traditional proxy contest because the bidder offered cold hard cash, rather than simply a plea for the target shareholders' vote in a directorial election.

Hostile tender offers became increasingly common in the 1960s, rising from

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<sup>99</sup> In a letter to Adolf Berle, William Douglas, who would later serve as SEC chair and then Supreme Court Justice, vowed that "you can count on me to pull an oar on federal incorporation." Letter from William O. Douglas to Adolph Berle (January 3, 1934)(on file with the Library of Congress, Douglas Papers, Container No. 2).

<sup>100</sup> Federal incorporation was not pursued until the late 1930s, and it was packaged with an unpopular antitrust bill. For a discussion of the missteps that doomed the proposal, see JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 208-210 (1982).

<sup>101</sup> The Young contest and its implications for American corporate governance and finance, are discussed in RON CHERNOW, *THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE* 508-511 (1990).

<sup>102</sup> For a contemporary review of a book chronicling the New York Central fight and eight other "spectacular proxy battles that have shaken American enterprise during the past decade," including a control battle over Montgomery Ward, see Anthony Arau, *Wanted: Proxies*, N.Y. TIMES, Nov. 25, 1956, at 308 (reviewing DAVID KARR, *FIGHT FOR CONTROL* (1956)).

seventy-nine from 1956-1960, to nearly twice that number from 1964-66.<sup>103</sup> Although a prescient 1965 article by Henry Manne stoutly defended the governance benefits of takeovers, in most quarters they were deeply controversial.<sup>104</sup> The premier Wall Street investment banks and law firms refused to represent bidders in a hostile takeover. This left the practice to scrappy upstarts like Joseph Flom of the law firm now known as Skadden, who became the leading takeover lawyer by taking cases the white shoe firms refused to touch.

As takeovers and other merger and acquisition activity intensified, lawmakers passed important reforms in the late 1960s. The first was the 1967 amendments to Delaware's General Corporation Law. Based on the recommendations of a "revision committee" commissioned in 1967, Delaware passed its most sweeping corporate law reforms since the end of the nineteenth century.<sup>105</sup> Among the key changes made by the 1967 amendments were a sharp expansion of the powers of a corporation to indemnify its directors, an attempted codification of the standard for reviewing self interested transactions, a provision authorizing cashout mergers, and a reduction of the availability of appraisal rights.<sup>106</sup> Although none of the major changes were directly aimed at the surge in hostile takeover bids, the reforms were designed to address concerns that had frequently been raised by managers. Expanded indemnification provided more protection against the possibility of fiduciary duty litigation, and retrenchment on appraisal rights smoothed the skids for large corporations that had embarked on acquisition campaigns.

More important than the details was the overall effect of the reforms. By the early 1960s, Delaware's pre-eminence as the leading state of incorporation had started to fade. The 1967 reforms spurred a dramatic increase in incorporations and reincorporations.<sup>107</sup> By the 1980s, when the biggest judicial challenges to hostile takeovers began, nearly all of the most important cases would make their way through the Delaware courts.

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<sup>103</sup> See Note, *Cash Tender Offers*, 83 HARV. L. REV. 377, 377 n.1 (1969).

<sup>104</sup> Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

<sup>105</sup> The template for Delaware corporate law was its 1899 Act, which had been patterned on New Jersey's corporate law statute.

<sup>106</sup> The changes are described in detail in S. Samuel Arshat & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. L. 75 (1967).

<sup>107</sup> See, e.g., William W. Bratton & Joseph A. McCahery, *The Content of Corporate Federalism*, 21-22 (unpublished manuscript, 2004)(noting that Delaware's revenues from chartering had dropped to 7% of its total revenues by 1963, but that its share of the market for incorporations has steadily increased since the 1967 amendments).

The ground rules that defined how the 1980s takeover bids were structured were put in place by the other major 1960s reform, the Williams Act. In its original incarnation, as introduced by New Jersey Senator Harrison Williams in 1965, the bill would have made it unlawful for a bidder to acquire more than 5% of a target company's stock "until the expiration of twenty days after such person has sent to the [target company], and has filed with the [SEC] a statement" describing, among other things, "the background and identity of all persons" making the bid, the source of the bidder's funds, and the dates and prices at which the bidder had previously purchased stock.<sup>108</sup> In effect, the original bill would have required bidders to give twenty days notice to the target company, so that the target had plenty of time to get its defenses ready. Over the next several years, the SEC worked with Senator Williams and the Senate Committee on Banking and Currency to refine the bill. At the principal hearing held on the proposed legislation, a parade of witnesses questioned the proposal for prior disclosure, while mostly agreeing with recommendations to require bidders to pay the same amount to all tendering shareholders and giving shareholders the right to withdraw their tender for a period of time.<sup>109</sup>

As enacted in 1968, the Williams Act requires disclosure by any party making a tender offer that would give it more than five per cent of the target's stock; gives shareholders the right to withdraw stock they had initially tendered to the bidder for the first seven days of the offer; requires a bidder to purchase stock on a pro rata basis, rather than purchasing first from the shareholders who tender first; requires the bidder who raises its bid price to pay the higher price even to shareholders who tendered at the lower price; requires that the offer be kept open at least forty days; and prohibits fraud by either side in a tender offer campaign.<sup>110</sup> The overall objective of the new rules was to prevent bidders from conducting so-called "Saturday night special" tender offers—offers that put pressure on shareholders to tender by requiring a rapid decision and making the offer available on a first come, first served basis. Under the new rules, shareholders would have more time to decide and would not be penalized for being the last to tender.

The mantra of the legislative debates was "neutrality." According to its proponents, the Williams Act would level the playing field between bidders and

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<sup>108</sup> S. 2731: A Bill Providing for Fuller Disclosure of Corporate Equity Ownership of Securities Under the Securities Exchange Act of 1934, 89<sup>th</sup> Cong. 1<sup>st</sup> Sess. at 2-3 (Oct. 22, 1965).

<sup>109</sup> The testimony is recounted in more detail in Part IV(C)(ii), *infra*.

<sup>110</sup> For an overview of the Williams Act changes, see, e.g., Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1254-60 (1973).



target managers by preventing bidders from using the blitzkrieg tactics that they had sometimes employed. In reality, of course, leveling the playing field meant helping target managers out in the name of shareholder choice. Managers clearly benefited from the new rules, since they now had enough time to wage an effective campaign against a hostile bidder. The bidders clearly lost. Whether shareholders won or lost is a closer question, since they benefited from the elimination of coercive bids but lost to the extent the new rules had a chilling effect on cash tender offers.

The final pieces in the puzzle of US takeover regulation came in the wake of the takeover boom of the 1980s.<sup>111</sup> Fueled by a combination of Michael Milken's discovery of the financing potential of high yield debt, deregulation, and a gentler approach by the Reagan administration to antitrust regulation, takeover activity soared to a level not seen since the great merger wave at the end of the Gilded Age. Target managers fought back with a variety of defensive strategies, the most dramatic of which was implementation of the poison pills pioneered by Marty Lipton of Wachtell, Lipton. Since the poison pill seemed to be capable of stopping a bidder in its tracks, bidders challenged pills and other defenses as an impermissible interference with their efforts to make a tender offer to target shareholders.

The battleground for these challenges was the courts of Delaware, the state in which approximately half of America's largest corporations were incorporated. In 1985, the Delaware Supreme Court issued three landmark opinions that completed the landscape of American tender offer regulation. In *Moran v. Household Int'l, Inc.*, Delaware held that poison pills are not per se impermissible, despite the fact that they discriminate between the tender offer bidder and other shareholders of the target company.<sup>112</sup> In *Unocal* and *Revlon*, the court then sketched out the initial limitations of target managers' use of poison pills and other defenses.<sup>113</sup> In order to defend against a takeover, managers would be required to show that the hostile offer represented a threat to the corporation and that the defense was reasonably proportionate to the threat. If it became clear that the company would be sold or broken up, managers' use of defenses would be limited still further: defenses would be permissible only to the extent target managers used them to try to get the highest price for their shareholders.

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<sup>111</sup> Milken and the development that laid the groundwork for the takeover era are surveyed in more detail in SKEEL, *supra* note 59, at 111-30.

<sup>112</sup> 500 A.2d 1346 (Del. 1985).

<sup>113</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985).

Although the Delaware caselaw gave them far more discretion than they would enjoy in a shareholder choice regime, target managers persuaded the legislatures of other states to give them even more protection. By the end of the 1980s, over forty states had enacted antitakeover legislation that protected the managers of companies incorporated in the state. In many states, the legislation was enacted at the behest of a particular company. In a few others, the debate was somewhat more prolonged. But nearly everywhere, state legislatures gave target managers new tools for resisting unwanted takeover bids.<sup>114</sup>

## B. What Happened in the UK?

As in the United States, the history of hostile takeovers in the UK began in the early 1950s. The first wave of hostile takeovers was fuelled by extraordinary opportunities for asset arbitrage that were created by the economic upheavals of the postwar period.<sup>115</sup> The first successful bid, Charles Clore's takeover of shoe retailer J. Sears in early 1953, is a good illustration.<sup>116</sup> Clore realized that owing to inflation, Sears' portfolio of city center premises was substantially undervalued in its accounts.<sup>117</sup> Yet because investors' valuation heuristics were largely based on dividend yields, this was not reflected in its share price.<sup>118</sup> To exploit this, Clore made a tender offer directly to shareholders. It was considered very sharp practice, and came as an enormous shock for the company's

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<sup>114</sup> Corporate managers' success in persuading state legislatures to pass antitakeover statutes is analyzed in Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

<sup>115</sup> On the one hand, government-imposed dividend restrictions lead many companies to hoard cash (ECONOMIST, December 19, 1953, at 904; EDWARD STAMP & CHRISTOPHER MARLEY, ACCOUNTING PRINCIPLES AND THE CITY CODE: THE CASE FOR REFORM, 9 (1970)), whilst the Companies Act 1948 introduced new disclosure obligations, rendering such reserves more transparent than before (see, e.g., Les Hannah, *Takeover Bids in Britain Before 1950: An Exercise in Business "Pre-History,"* 16 BUS. HIST. 65, 75-76 (1974)). On the other hand, surging postwar inflation inflated the value of fixed assets, particularly land (see, e.g., *The Shareholder Today*, ECONOMIST, December 19, 1953, 903 at 904; *Mergers Take Over*, ECONOMIST, July 4, 1959, at 41). Yet UK investors were used to valuing stocks on the basis of dividend yields. Historically, very little financial information had been made available about listed companies, and investors relied upon regular dividends as a credible signal of managers' commitment to investors (see Brian R. Cheffins, *Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom*, Working Paper, University of Cambridge Faculty of Law, 2005). As a result, whilst the value of corporate assets rose, dividend restraint caused share prices to fall.

<sup>116</sup> Clore had, unsuccessfully, made the first hostile takeover *bid* two years earlier. See, e.g., *Offer For F. Gorringer Capital*, THE TIMES, April 28, 1951, at 9.

<sup>117</sup> *City Notes: The J. Sears Offer*, THE TIMES, February 5, 1953, at 10.

<sup>118</sup> See, e.g., GEORGE BULL & ANTHONY VICE, BID FOR POWER 30 (3<sup>rd</sup> ed., 1961).

management, and the City establishment in general.<sup>119</sup> The Sears board promised to increase dividends and to revalue the firm's property to reflect its higher current value.<sup>120</sup> But for the company's shareholders, this was too little, too late. A large majority accepted Clore's offer.<sup>121</sup>

As in the US, much of the British business community was initially outraged by the advent of the takeover bid, and believed that they were harmful for industry. Managers initially felt justified in defending themselves, as is illustrated by the notorious battle for Savoy Hotel Ltd. This began later in 1953, when Harold Samuel, another financier specializing in take-overs, started buying that company's shares.<sup>122</sup> Samuel intended to convert the Savoy's Berkeley Hotel into commercial offices. The Savoy board's response was what would now be seen as a classic "lock-up" strategy. They arranged for the Berkeley Hotel to be sold to a new entity, Worcester (London) Co Ltd, and leased back to Savoy on terms that required the building to be used only as a hotel.<sup>123</sup> The voting shares in Worcester were allotted to the trustees of Savoy's pension fund—one of whom, conveniently, was chairman of its board. There was thus no way that Samuel could convert the hotel into offices, even if he succeeded in ousting the incumbent board.<sup>124</sup>

The Savoy board's tactics were highly controversial, because their shareholders were given no say in the bid's outcome. The subsequent outcry led the UK's Board of Trade to investigate the directors' conduct.<sup>125</sup> The Board's report was prepared by E. Milner Holland Q.C., a leading company law barrister. Milner

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<sup>119</sup> Clore, a Russian émigré turned City financier, was willing to countenance tactics that City insiders considered beyond the pale. See, e.g., *Charles Clore: Obituary*, THE TIMES, November 19, 1979, at 26.

<sup>120</sup> This tactic had worked for the board of a previous target of Clore's: see *Gorrings Bids Fails*, THE TIMES, June 1, 1951, at 9. See also *supra* note 116.

<sup>121</sup> Clore then took advantage of the inflated property prices by selling and leasing back much of the company's retail property (*City Notes: J. Sears' Property Sales*, THE TIMES, March 5, 1954, 13).

<sup>122</sup> *Savoy Shares Inquiry*, THE TIMES, 1 December 1953, at 8; E. MILNER HOLLAND QC, REPORT OF THE BOARD OF TRADE INVESTIGATION INTO THE SAVOY HOTEL CO LTD, 3-13 (1954).

<sup>123</sup> *Savoy Group's New Company*, THE TIMES, December 7, 1953, 17; *Battle for the Savoy*, ECONOMIST, December 12, 1953, at 831, 831-32.

<sup>124</sup> See L. C. B. Gower, *Corporate Control: The Battle for the Berkeley*, 68 HARV. L. REV. 1176, 1179-80 (1955); RONALD W. MOON, BUSINESS MERGERS AND TAKE-OVER BIDS: A STUDY OF THE POST-WAR PATTERN OF AMALGAMATIONS AND RECONSTRUCTIONS OF COMPANIES, 128-32 (5<sup>th</sup> ed. 1976).

<sup>125</sup> *Battle for the Savoy*, ECONOMIST, December 12, 1953, 831 at 832.

Holland concluded that the Savoy directors had overstepped the mark, because although they had acted in good faith, the effect of the scheme was to “disable [stockholders] from varying the decision of the [b]oard”.<sup>126</sup> However, his report lacked the binding force of a court judgment;<sup>127</sup> indeed the Savoy board had taken advice from another leading barrister to the effect that their scheme was perfectly lawful.<sup>128</sup> Direct precedents on the point were non-existent.

It was against this background of controversy that the notorious battle for British Aluminium was played out. At the end of 1958, the managers of British Aluminium Ltd (“BA”) received approaches from two rival camps: one from the US Reynolds Metal Company, in partnership with UK-based Tube Investments (“TI-Reynolds”), and the other from the Aluminium Company of America (“Alcoa”). Without informing their shareholders of these developments, BA’s board rejected TI-Reynolds’ approach, instead agreeing to a deal with Alcoa under which the latter was issued with new shares amounting to a one-third stake in BA.<sup>129</sup> It was only when TI-Reynolds made clear that they intended to go over the BA directors’ heads, with an offer directly to the shareholders that the directors publicly revealed the Alcoa deal.<sup>130</sup> The BA board then tried to bribe their shareholders with a generous dividend increase, which boosted the share price considerably.<sup>131</sup> This, however, only served to provoke further anger that Alcoa had been permitted to buy a large block of shares at the earlier—undervalued—price.<sup>132</sup> Shareholders’ response was quick and devastating: they dumped BA stock as fast as TI-Reynolds could buy it, thereby sealing the incumbent management’s fate.<sup>133</sup>

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<sup>126</sup> MILNER HOLLAND, *supra* note 122, at 26.

<sup>127</sup> Gower, *supra* note 124, at 1192-93.

<sup>128</sup> MOON, *supra* note 124, at 130.

<sup>129</sup> See *Battle for British Aluminium*, ECONOMIST, December 6, 1958, at 913, 913-15. The BA board’s choice was probably influenced by the fact that Alcoa intended to permit them to remain in office (see, e.g., *Alcoa Proposal for Representation*, THE TIMES, December 2, 1958, at 10; *Choice in British Aluminium*, ECONOMIST, December 13, 1958, at 1005, 1006). Under BA’s constitution, issuing new shares did not require shareholder approval.

<sup>130</sup> *British Aluminium Reveals Contract with Alcoa*, THE TIMES, November 29, 1958, at 12; *British Aluminium Board’s Statement*, THE TIMES, December 6, 1958, 11.

<sup>131</sup> *Dividend Raised to Counter Bid*, THE TIMES, December 20, 1958, at 6.

<sup>132</sup> *Letters to the Editor*, THE TIMES, December 11, 1958, 11; *British Aluminium: A Reply Under Pressure*, ECONOMIST, December 27, 1958, 1173; *Letters to the Editor*, THE TIMES, January 9, 1959, 11.

<sup>133</sup> See, e.g., *Control Now in Sight for Aluminium*, THE TIMES, January 7, 1959, at 10; *T.I.-Reynolds Gain Control of British Aluminium*, THE TIMES, January 8, 1959, at 10; *T.I. Claim 80% Shares Held*,

The BA board's conduct provoked widespread calls for takeover regulation. In July 1959, the Governor the Bank of England secretly invited a Committee comprised of trade groups representing merchant banks, institutional investors, the largest commercial banks and the London Stock Exchange to devise a code of conduct to regulate takeover bids.<sup>134</sup> This initiative seems to have been prompted, at least in part, by the fear that if action were not seen to have been taken, then the matter would be taken out of the City's hands by legislation.<sup>135</sup> Indeed, shortly afterwards, Prime Minister Harold Macmillan announced a review of the working of company law, which was to include takeovers.<sup>136</sup>

In the autumn of 1959, the Bank's Committee announced the "Notes on Amalgamation of British Businesses." The *Notes* contained a series of general guidelines that were "concerned primarily to safeguard the interests of shareholders."<sup>137</sup> The first of the *Notes*' four main principles stated that there should be no interference with the free market in shares, and the second that it was to be for the shareholder himself to decide whether to sell. The *Notes* also called for shareholders to be given enough information to make an intelligent decision, and enough time to digest it.<sup>138</sup> The principle of shareholder primacy—and correlative board neutrality—was thus established. In keeping with the gentlemanly spirit in which the City did business at the time, the principles established by the *Notes* were dubbed the "Queensbury Rules," after the rules drafted by the Marquess of Queensbury to regulate prize-fighting.<sup>139</sup> The Bank

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THE TIMES, January 10, 1959, at 10; *War to What Purpose?*, ECONOMIST, January 10, 1959, at 145,145-47; *British Aluminium Board Changes*, THE TIMES, February 18, 1959, at 10.

<sup>134</sup> See *Takeover Study and Other Needed Reforms*, THE TIMES, October 13, 1959, 19; *Rules for Takeovers?*, ECONOMIST, October 17, 1959, 270 at 270-71.

<sup>135</sup> See HANSARD, HC Deb, 2 June 1959, Mr. Sydney Irving MP (call for Parliamentary Committee to investigate take-over bids and create code of ethics); *A Problem of Communication: The City Starts to Explain Itself*, THE TIMES, October 19, 1959, iii ("In the light of recent events it is clear that some official (or semi-official through the relevant trade association) regulation is needed if the public is to have the protection it ought to have").

<sup>136</sup> The Board of Trade announced the setting up of the Jenkins Committee on company law in November. See, e.g., 1959: *Company Law*, THE TIMES, November 28, 1959, at 7.

<sup>137</sup> *Editorial: Take-over Ethics*, THE TIMES, Oct. 31, 1959, at 7.

<sup>138</sup> See, e.g., *City Code of Conduct on Take-over Bids*, THE TIMES, October 31, 1959, at 5-6; ECONOMIST, October 31, 1959, 440-42.

<sup>139</sup> "These are rules of conduct which have been followed by sensible and responsible people in industry and in the City for most of the time," as the *Economist* put it. "They do not deny businessmen the right to fight out an issue, but they do establish Queensbury rules against low hitting and butting with the head." ECONOMIST, October 31, 1959, 442.

of England's circulation of the *Notes* seemed to have the effect of heading off demands for legislative intervention.<sup>140</sup>

Although the *Notes* were generally well-received, and were revised and improved in 1963,<sup>141</sup> their influence on the UK takeover market was limited by the lack of mechanisms for adjudication and enforcement. Things came to a head in 1967, when in a battle between two bidders for control of Metal Industries Ltd ("MI"), a third party bought a block of shares in the market and sold these to one of the bidders—enough to secure control.<sup>142</sup> Enough, that was, until MI's board responded by issuing fresh shares to the other bidder—the very tactic that had provoked outrage in the case of British Aluminium.<sup>143</sup> By the summer of 1967, *The Economist* concluded that the widespread evasion of the *Notes*' principles made them "a dead letter."<sup>144</sup>

The financial press suggested that the only hope for a well-functioning takeover market would be a governmental agency with oversight authority, along the lines of the SEC.<sup>145</sup> But a British SEC was not to be. In July 1967, Prime Minister Harold Wilson insisted that statutory rules were not the answer.<sup>146</sup> Within days, the Bank of England's Working Party had reconvened to begin

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<sup>140</sup> The only "hard law" reform that impinged upon takeovers was Board of Trade's introduction in 1960 of new rules for licensed securities dealers, which required bids to be open for a minimum of 21 days, and the disclosure of certain information about bidders. See *New Rules for Take-overs*, THE TIMES, May 10, 1960, at 20. Although the Jenkins Committee did make more extensive proposals in relation to takeovers, they were never implemented (see BOARD OF TRADE, REPORT OF THE COMPANY LAW COMMITTEE (THE "JENKINS REPORT"), Cmnd. 1749, at ¶¶ 265-294 (1962)).

<sup>141</sup> The *Revised Notes* were published on October 31, 1963. See, e.g., *Revised Code on Take-over Practices*, THE TIMES, October 31, 1963, at 19; *Take-over Bids: Principles and Procedure*, ECONOMIST, November 2, 1963, at 511.

<sup>142</sup> See, e.g., *Coup Behind the New Bid for MI*, THE TIMES, June 8, 1967, at 26; *Victory in MI Fight Cost Aberdare £14m*, THE TIMES, July 13, 1967, at 19.

<sup>143</sup> See *Thorn Deal with MI Strips Control Away From Aberdare*, THE TIMES, July 17, 1967, at 17; *All for the Lack of a Referee*, THE TIMES, July 17, 1967, at 21; *Back to the Jungle*, ECONOMIST, July 22, 1967, at 337-38. Contemporaneously, the board of International Distillers and Vintners used a similar tactic, staving off a hostile bid by persuading a friendly third party to buy a substantial stake in the market: see *Watney Mann was Mystery Buyer of IDV Shares*, THE TIMES, July 25, 1967, at 17.

<sup>144</sup> ECONOMIST, *supra* note 143, at 337. See also *The Takeover Code that Died*, THE TIMES, December 29, 1967, at 19.

<sup>145</sup> See, e.g., *The Case for a British SEC*, ECONOMIST, January 7, 1967, at 49; *Time for a Tough Line in the City*, THE TIMES, July 18, 1967, at 23.

<sup>146</sup> See ECONOMIST, *supra* note 143, at 338.

drafting a new set of takeover rules.<sup>147</sup> By the end of March 1968—the year when US lawmakers enacted the Williams Act’s federal tender offer rules—the draft *Takeover Code* was ready. The new *Code* was very much in the same shareholder-oriented spirit as the earlier *Notes*, but its form was rather more specific.<sup>148</sup> It consisted of a series of ten general principles, instantiated in 35 specific rules. Not surprisingly, many of its details could be traced to the problems that had surfaced in the takeover transactions of the previous years. The basic principle of shareholder choice, taken from the *Notes*, was now supplemented by a general ban on frustrating actions, and specific prohibitions of transactions likely to induce this—issuing shares, disposing of material assets or entering into a significant contract—without the approval of the shareholders. Similarly specific requirements were set out in relation to the equal treatment of shareholders.

For the first time, too, a body of individuals were entrusted with the task of “adjudicating” disputes about the application of the rules. The City Panel on Takeovers and Mergers was inaugurated on 27 March 1968. Its nine members, who were drawn from the organizations represented on the Working Party, consciously decided that pro-active involvement was better than an *ex post* judicial approach.<sup>149</sup> This soon became institutionalized as the Panel’s characteristic “real time” guidance in takeover cases.<sup>150</sup> However, the wholly non-executive Panel seems to have been overwhelmed by the volume of business—575 cases in its first year<sup>151</sup>—and its responses to several high-profile infringements of the Code were disappointing.<sup>152</sup> The *Economist* complained

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<sup>147</sup> *City Acts to Put its House in Order*, THE TIMES, July 22, 1967, at 17; *City Panel to Oversee Takeovers*, THE TIMES, September 21, 1967, 19; *Takeover Code: Enforceable*, ECONOMIST, September 23, 1967, at 1130.

<sup>148</sup> *A Momentous Stride Forward for the City*, THE TIMES, March 27, 1968, at 27.

<sup>149</sup> TAKEOVER PANEL, REPORT ON THE YEAR ENDED 31 MARCH 1969, at 4 (1969).

<sup>150</sup> *See, e.g., Familiar Technique of a “Quiet Word in the Ear,”* THE TIMES, June 15, 1968, at 13.

<sup>151</sup> TAKEOVER PANEL, *supra* note 149, at 8.

<sup>152</sup> These were (i) the Courtaulds-Dufay battle for International Paints, which involved a breach of the Code’s information requirements: *see, e.g., Courtaulds and Rule 14*, THE TIMES, June 19, 1968, at 24; (ii) the American Tobacco-Philip Morris battle for Gallaher, a British tobacco company: *see, e.g., City Row Flares as Panel Censures Gallaher Bid Deals*, THE TIMES, July 19, 1968, at 17; *Cazenove Unshaken by Panel’s Attack*, THE TIMES, July 20, 1968, at 11; *Takeover Panel’s Attack of Cold Feet*, THE TIMES, July 26, 1968, 24; and (iii) the battle for the *News of the World* newspaper, which first pitted Robert Maxwell against Rupert Murdoch: *see, e.g., Wanted: New Takeover Body*, THE TIMES, October 26, 1968, at 17; *News of the World: Maxwell Loses Vote, Panel Loses Face*, ECONOMIST, January 4, 1969, at 58. *See also* DAVID KYNASTON, THE CITY OF LONDON, VOL IV, 375-85 (2001).

that aggressive bidders were running a “coach and horses through the Code” and insisted that the time had come for a “professional referee” with a full range of legal sanctions at its disposal.<sup>153</sup> Although Prime Minister Harold Wilson announced he had “no desire to introduce legislation to force on the City the much more wide-ranging interference with free enterprise America has devised in the form of the Securities and Exchange Commission”,<sup>154</sup> the government made clear that they would be forced to legislate unless the Panel quickly reformed its oversight techniques.<sup>155</sup>

Over the next few months, three major changes were announced that would transform the Panel. First, the Panel was given a full-time executive staff, paid for by City institutions. Lord Shawcross, a political heavyweight who had formerly been both Attorney-General and President of the Board of Trade,<sup>156</sup> was persuaded to serve as non-executive Chairman, and Ian Fraser, an experienced takeover specialist from S.G. Warburg, was recruited as executive Director-General.<sup>157</sup> Secondly, due process protection was added to the Panel’s procedures. An Appeal Committee was constituted, the first President of which was a former Law Lord.<sup>158</sup> Finally, and most importantly, the sanctions available to Panel were dramatically enhanced. These piggybacked on the existing authority of the Stock Exchange and the Board of Trade.<sup>159</sup> The Stock Exchange had the power to censure, suspend or expel a company from the Official List, and the Board of Trade had similar authority over licensed share dealers. Moreover, the various trade associations represented in the Working Party agreed to impose sanctions upon their members—up to and including

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<sup>153</sup> *Coach and Horses Through the Code*, ECONOMIST, July 20, 1968, at 76, 76-77.

<sup>154</sup> *Quoted in* JOHNSTON, *supra* note 66, at 49-50.

<sup>155</sup> *See, e.g., BoT Gives Warning of Takeover Discipline*, THE TIMES, November 1, 1968, at 21; *Takeover Panel Gets One More Chance*, THE TIMES, November 7, 1968, at 16; *Takeover Code Will Remain Voluntary*, THE TIMES, December 12, 1968, at 21.

<sup>156</sup> *See, e.g., Two New Cabinet Ministers: Sir Hartley Shawcross and Mr Alfred Robens*, THE TIMES, April 25, 1951, at 6.

<sup>157</sup> *See, e.g., Shawcross Asked to Head Takeover Panel*, THE TIMES, February 21, 1969, 17; *Enter the New Police Chiefs*, ECONOMIST, March 1, 1969, at 76. As part of his preparation for the role, Fraser spent a week at the SEC in Washington to learn about the US approach to takeover regulation. *See Panel Chief Studies US Methods*, THE TIMES, April 28, 1969, at 17.

<sup>158</sup> *See Lord X and the City*, THE TIMES, May 2, 1969, at 29 (naming Lord Pearce).

<sup>159</sup> *Teeth at Last—But How Will they Bite?*, THE TIMES, February 26, 1969, at 29; *Vital Assignment for Mr Fraser*, THE TIMES, April 29, 1969, at 27; *The Panel: Big and Little Sanctions*, ECONOMIST, May 3, 1969, at 74.



stripping them of membership—if asked to do so by the Panel.<sup>160</sup> This gave the Panel a range of responses, ranging from public censure through trade association sanctions to complete withdrawal of the right to deal in securities and/or de-listing. The preamble to the new Code made this clear:

The Code has not, and does not seek to have, the force of law, but those who wish to take advantage of the facilities of the securities markets in the United Kingdom should conduct themselves in matters relating to take-overs according to the Code. Those who do not so conduct themselves cannot expect to enjoy those facilities and may find that they are withheld.<sup>161</sup>

The status of the Panel as regulators of UK takeovers was cemented by its very firm, but even-handed, response to problems in a 1969 takeover of Pergamon Press by American Leasco Data Processing Equipment Corp.<sup>162</sup> A series of revelations about murky accounting practices and insider dealing at Pergamon, 31% of which was held by Robert Maxwell, gave Leasco cold feet about the deal.<sup>163</sup> The Panel insisted on full disclosure, and asked the Board of Trade to conduct an investigation into Pergamon's affairs.<sup>164</sup> The Panel's decisive intervention greatly enhanced its credibility and quieted calls for a British SEC.<sup>165</sup>

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<sup>160</sup> See, e.g., *Support Grows for City's New Code*, THE TIMES, June 30, 1969, at 19. The trade associations pledging to bind their members to observe the Code were the Council of the Stock Exchange (stockbrokers and jobbers), the Issuing Houses Association (merchant banks), the British Insurance Association, the Association of Unit Trust Managers and the Association of Investment Trust Companies.

<sup>161</sup> TAKEOVER PANEL, THE CITY CODE ON TAKE-OVERS AND MERGERS (1969), Preamble.

<sup>162</sup> See Michael Blanden, *The City Regulations on Mergers and Takeovers*, in READINGS ON MERGERS AND TAKEOVERS (J.M. SAMUELS ED., 1972), 199 at 205-206.

<sup>163</sup> See, e.g., *600,000 Pergamon Shares Sold*, THE TIMES, August 21, 1969, at 15; *Americans Drop Bid for Maxwell Company*, THE TIMES, August 22, 1969, at 1; *Stock Exchange is Asked to Suspend Pergamon Dealings*, THE TIMES, August 22, 1969, at 15.

<sup>164</sup> See, e.g., *Pergamon: Takeover Panel Calls for Board of Trade Enquiry*, THE TIMES, August 28, 1969, at 15; *New Shock for the City: Takeover Panel to Widen its Inquiries*, THE TIMES, August 29, 1969, at 17; *A True and Fair View*, ECONOMIST, August 30, 1969, at 43-44.

<sup>165</sup> See, e.g., *More Questions for the Takeover Panel*, THE TIMES, November 21, 1969, 27; *Takeover Panel: Getting to Know You*, ECONOMIST, May 9, 1970, at 83 (“quite an achievement for an instrument created by the City's institutions themselves, by common consent owing much to the prestige which Lord Shawcross has brought to the chairmanship and the appointment of a permanent director-general”); *Takeover Panel Sets Standards*, THE TIMES, March 9, 1972, v (“the panel have been outstandingly successful by the standards of 1969”);

Although the Panel's immediate future was safe, its Chairman, Lord Shawcross, was well aware of how little it would take, especially with the left-leaning Labour governments of the 1970s, to provoke legislative intervention.<sup>166</sup> In his view, the Panel needed to do more than simply to reflect contemporary best practice. If another scandal occurred, critics would simply conclude that "best" practice was not good enough. Rather, it had to ensure that there were no further scandals. To do this, the Panel became involved in the continuous development of *better* practice. It updated its rules pro-actively in response to developments in the market,<sup>167</sup> in so doing focusing heuristically on the needs of the "small shareholder".<sup>168</sup> As he re-iterated in the Chairman's statements to successive Annual Reports of the Panel, Shawcross firmly believed that the Panel was able to perform this norm development function more quickly and effectively than a regulator established by a legislative system, such as the SEC.<sup>169</sup>

One of the most important such innovations was the so-called "mandatory bid" rule. Following the announcement of two rival bids for Venesta International in 1971, David Rowland, a shareholder in the company, started to buy its shares heavily in the market. Whilst stating simply that he wished to preserve the value of his investment by avoiding the takeover, he obtained a controlling interest in the company without making a bid. The Panel were concerned that Rowland's open market purchases denied the company's small shareholders the opportunity to sell at the favorable terms Rowland had offered.<sup>170</sup> Their response was a new rule requiring any person who purchased 40% or more of a company's shares to

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<sup>166</sup> See *Who Should Regulate the City?*, THE TIMES, May 30, 1974, 1; *Stock Exchange Attacks "Alarming Prejudice" of Labour Green Paper*, THE TIMES, July 18, 1974, 21; TAKEOVER PANEL, REPORT FOR THE YEARS ENDED 31 MARCH 1975 AND 1976, at 3 (1976).

<sup>167</sup> See, e.g., TAKEOVER PANEL, REPORT FOR THE YEAR ENDED 31 MARCH 1973, at 3, 9-10 (1973) (urging legislation on insider dealing); *The City Code and Shareholder Rights*, THE TIMES, April 8, 1974, 18 (new rule restricting a bidder's ability to withdraw its bid).

<sup>168</sup> See, e.g., TAKEOVER PANEL, REPORT FOR THE YEAR ENDED 31 MARCH 1978, at 5 (1978) ("[T]he interests of *all* shareholders have to be considered. ... [I]t is right that the institutions should increasingly interest themselves in the management of companies in which they invest and in so doing should regard themselves as in a sense representing the interest of all shareholders.") (emphasis in original); see also TAKEOVER PANEL, REPORT FOR THE YEAR ENDED 31 MARCH 1980, at 6 (1980) ("I am influenced by my keen belief that small shareholders should be given every assistance and protection.")

<sup>169</sup> See, e.g., TAKEOVER PANEL, REPORT FOR THE YEAR ENDED 31 MARCH 1973, at 3 (1973); TAKEOVER PANEL, REPORT FOR THE YEAR ENDED 31 MARCH 1974, at 3-4 (1974); TAKEOVER PANEL, REPORT FOR THE YEAR ENDED 31 MARCH 1975-76, at 3-4 (1976).

<sup>170</sup> See, e.g., *New Problem for the Panel*, THE TIMES, December 18, 1971, 19.

make a bid for the remainder.<sup>171</sup> The threshold was lowered to 30% in 1974, where it has since remained.<sup>172</sup>

The emergence of the Panel as the principal source of regulatory oversight over UK takeovers can hardly be described as an illustration of spontaneous order in action. Rather, it is better characterized as coerced self-regulation, made under a clear governmental threat of intervention.<sup>173</sup> But the regulatory strategy that emerged during the same era as Delaware enacted its 1967 reforms and the SEC helped to shape the 1968 Williams Act looks remarkably different from the US approach. Unlike in the US, where the contours of takeover regulation are hammered out in the courts, the Panel approach managed to keep lawyers out of the process. And despite the steady drumbeat of calls for a “professional regulator,” UK lawmakers continued to look to coerced self-regulation rather than an American-style SEC as the principal source of oversight in the takeover context. In the words of a leading English judge, Sir John Donaldson MR:

The Panel on Take-overs and Mergers is a truly remarkable body. Perched on the 20th floor of the Stock Exchange building in the City of London, both literally and metaphorically it oversees and regulates a very important part of the United Kingdom financial market. Yet it performs this function without visible means of legal support.<sup>174</sup>

#### IV. EXPLAINING THE DIVERGENCE: FROM PROCESS TO SUBSTANCE

Having chronicled the remarkable divergence of US and UK takeover regulation, we turn now to the question of *why* these two countries have taken such different paths when it comes to regulating takeovers. We begin with the most obvious explanation, which is derived from the marvels of American federalism. As we shall see, however, this “orthodox” story raises nearly as many questions as it answers. We develop a richer analysis that draws on the

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<sup>171</sup> See *New Takeover Code Rule: Buyer Gaining 40pc Stake Must Bid for Remainder*, THE TIMES, January 19, 1972, 17; TAKEOVER PANEL, REPORT ON THE YEAR ENDED 31 MARCH 1972, at 7 (1972). It closely complemented another change requiring a bidder who had acquired more than 15% of the target’s shares in the market during the previous year to make a *cash* offer at the highest price paid during that time. See *An Issue of Principle for the Takeover Panel*, THE TIMES, March 31, 1970, at 23; *Need for Rapid Changes in the Code*, THE TIMES, August 23, 1971, at 14.

<sup>172</sup> *Revised City Code Sets Out New Rules on Mandatory Bids*, THE TIMES, June 6, 1974, at 19.

<sup>173</sup> See IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 101-132 (1992).

<sup>174</sup> *R v Panel on Take-overs and Mergers, ex parte Datafin plc* [1987] QB 815 at 824.

historical developments described in the previous part, focusing in particular on the influence of institutional shareholders in the UK and on the foreclosure of self regulation in the US. Both paths, it turns out, were the largely unintended consequences of legislation that had other objectives.

#### A) The Orthodox Story: Federalism and Pro-Manager Takeover Law

For even longer than they have been debating directors' proper response to takeovers, American corporate scholars have debated whether Delaware's supremacy as the state of choice for America's largest corporations is the product of a "race to the bottom" or a "race to the top."<sup>175</sup> The race to the bottom view posits that state lawmakers cater to managers, and thus have powerful incentives to favor managers at the expense of shareholders, whereas race to the top advocates believe that market pressures force Delaware and other states to regulate with shareholders in mind. The federalism that makes this state lawmaking possible provides the most obvious explanation for the US approach to takeover regulation.

In the past decade, a subtler version of the original race to the bottom theory has emerged, and has become increasingly influential in corporate law circles. This view proposes that charter "competition" is hardly a competition at all. Delaware, which roughly sixty per cent of the largest corporations now call home, has a monopoly share of the market.<sup>176</sup> Delaware's monopoly is made possible, in part, by the fact that there is no open, nationwide competition between Delaware and forty-nine other states. Rather, Delaware competes with just one other state at a time— the "home" state of a corporation that is considering relocating to Delaware.<sup>177</sup> The upshot is that Delaware has at least some ability to favor managers' interests, and it can charge supracompetitive prices for the privilege of incorporating in the nation's second smallest state.

It is a short step from this new orthodoxy to a straightforward political explanation for the divergence of US and UK takeover regulation. In the US,

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<sup>175</sup> The wellspring of the debate in its current incarnation was a scathing indictment of Delaware by former SEC chair William Cary: William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). Delaware's leading defender is Roberta Romano. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993). With the advent of the EU, the debate has become a staple in the European literature as well. See generally sources cited *supra* note 7.

<sup>176</sup> See, e.g., Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

<sup>177</sup> See, e.g., Lucian Bebchuk, Alma Cohen, & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law*, 90 CAL. L. REV. 1775 (2002).

federalism has amplified the voice of corporate managers. Because they worry that managers will pack the company's bags and move elsewhere if the state is insufficiently attentive to the managers' needs, state lawmakers have powerful incentives to keep corporate managers happy.<sup>178</sup> This suggests that managers will often get what they want both in Delaware and in other states. In the UK, by contrast, which does not have this federalist structure, corporate managers exert far less influence.<sup>179</sup>

The orthodox account rings true in some respects. Managers clearly do influence the shape of state corporate law— particularly with respect to takeovers. But the federalism story also has at least two puzzling limitations. First, whilst it offers a superficially plausible explanation for the general substantive content of US takeover regulation, it implies that Delaware law is likely to be more manager-friendly—and less efficient—than the laws of other states. After all, if Delaware judges and lawmakers have a greater stake in pacifying corporate managers than any other state, their handiwork should pander correspondingly more to managers' interests. Yet this conclusion fits poorly with the existing evidence.<sup>180</sup> Delaware was one of the last states to enact an antitakeover statute, for instance, and its statute gives managers far less discretion than those rushed into the code books by other state legislatures.<sup>181</sup> There is also strong empirical evidence that reincorporating in Delaware increases a company's value, rather than undermining it.<sup>182</sup> Delaware's critics have labored mightily to explain these observations, but the evidence suggests

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<sup>178</sup> Reincorporation does require a shareholder vote, but race to the bottom theorists argue that the vote is an ineffective check, either because of shareholders' collective action problems or because the reincorporation vote is muddied by other, more positive reasons for moving to the new state.

<sup>179</sup> Geoff Miller, one of the few commentators who have considered the US-UK contrast in takeover regulation, reaches a similar conclusion in a brief discussion of the political dynamics. "The federal principles which generate strong pressures for antitakeover legislation at the state level in the U.S.," he notes, "are not present in England. ... In such an environment, antitakeover legislation is unlikely to be observed." Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between The United States and England*, 1998 COLUM. BUS. L. REV. 51, 75 (1998). Miller's analysis differs somewhat from ours in that he focuses on the political influence of potential bidders and targets, but doesn't consider the role of the shareholder and merchant banking interests who historically were influential in shaping the UK regulatory environment.

<sup>180</sup> See, e.g., Johnathan R. Macey, *Displacing Delaware: Can the Feds do a Better Job Than the States in Regulating Takeovers*, 57 BUS. LAW. 1025, 1034-36 (2002).

<sup>181</sup> See, e.g., Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORD. L. REV. 843 (1993).

<sup>182</sup> Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001). But see Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L.E. & ORG. 32 (2004) (suggesting that Delaware's positive effect on share prices was temporary and Delaware now has no statistical effect except with small firms).

that a theory predicated on an assumption that Delaware corporate regulation is less efficient than other states may not be the whole story.

The second limitation deepens the mystery. As our historical analysis has shown, the single most striking difference between US and UK takeover regulation is not the substance but the *mode* of regulation: the US looks to formal law, whereas norms-based self regulation holds sway in the UK. Yet the orthodox federalism story does not seem to give us tools for understanding why US and UK takeover regulation differ not just in substantive terms, but also in the principal mode of regulation.<sup>183</sup> A more compelling political account must also explain the divergent *modes* of regulation.

To identify the starting points for a richer political account, we need only return to our historical overview and ask, which of the players and events that figured prominently in the historical development of US and UK takeover regulation seem to be missing from the orthodox federalism story? The answers, in our view— the dogs that didn't bark in the last section—are institutional shareholders in the UK, and the early twentieth century securities and banking legislation that determined the path of US corporate regulation. Together, they hold the key to understanding the divergent modes of regulation in the US and UK. This time we begin our account across the water in the UK.

## B) Self-Regulation by Institutional Investors: The Case of the UK

Institutional shareholders played a far greater role in the development of UK takeover regulation than in the US. Every time large financial institutions were poised to play an outsized role in American corporate governance in the twentieth century, politicians intervened, forcing corporate ownership to remain fragmented and discouraging big financial institutions from substantially raising their profile.<sup>184</sup> Although mutual funds, pension funds and other institutional shareholders now hold a large percentage of US equities, their holdings were relatively insignificant during the crucial periods in the development of takeover regulation (see Figure 1). It was only in the 1990s—by which time the contours of Delaware's takeover doctrine had largely been established—that US

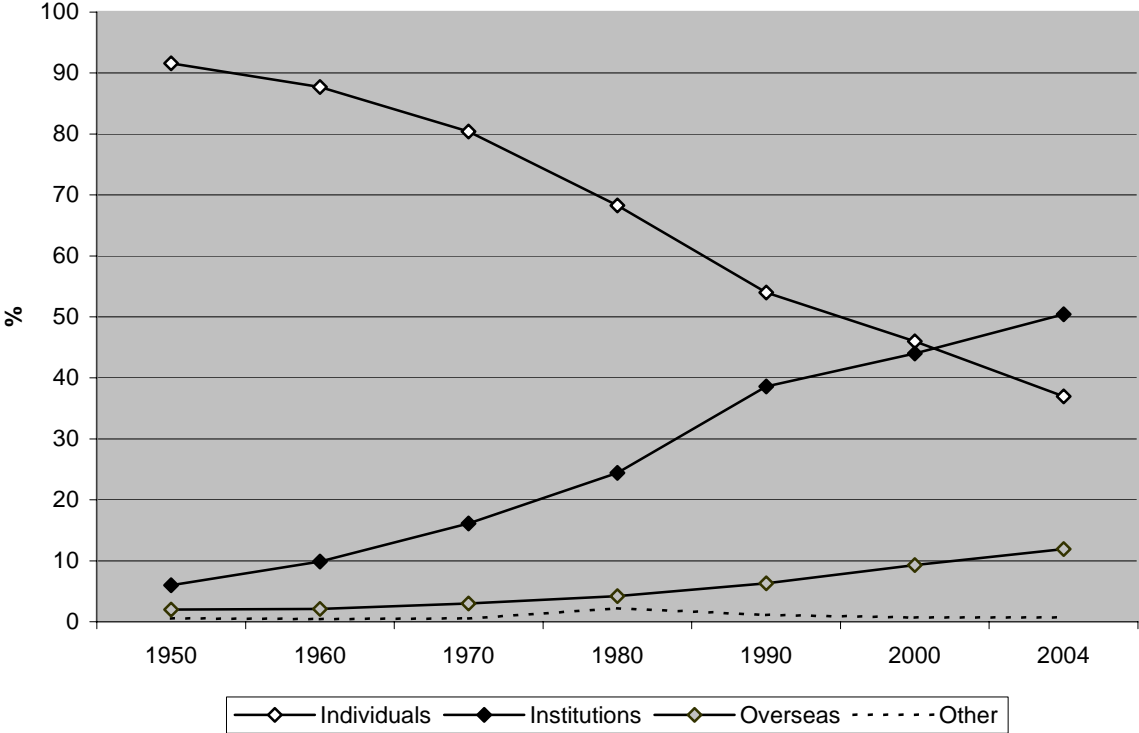
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<sup>183</sup> Thus, as noted earlier, Lucian Bebchuk has pointed to the UK approach in support of an argument for new mandatory shareholder choice regulation in influential recent work without addressing the fact that UK takeover regulation relies on self regulation rather than formal, mandatory law. See *supra* note 3; Bebchuk, *supra* note 3, at 847-50.

<sup>184</sup> This point, discussed in more detail *infra*, text to notes 229-233, is generally associated with Mark Roe's classic work on the politics of American corporate governance: ROE, *supra* note 6.

institutional investors became a significant force in corporate governance.<sup>185</sup> The impetus behind the legislation that restricted institutions was a populist desire to rein in the monopoly power of the “Money Trust.” This had the largely unintended consequence of granting managers considerable autonomy from shareholder control.

**Figure 1: Share ownership patterns in the US, 1950-2004<sup>186</sup>**



In contrast, institutional investors became important much earlier in the UK. The proportion of UK stocks owned by pension funds, insurance companies and unit trusts (the British equivalent of mutual funds) rose dramatically during the 1960s and 70s, as Figure 2 illustrates. Unlike their American counterparts, British institutions were not held back from investing in stocks. Indeed, quite the reverse. The emergence of strong institutional investors in Britain was an unintended consequence of various legislative measures that had the effect of actively promoting their ownership of stock.<sup>187</sup> Three were particularly

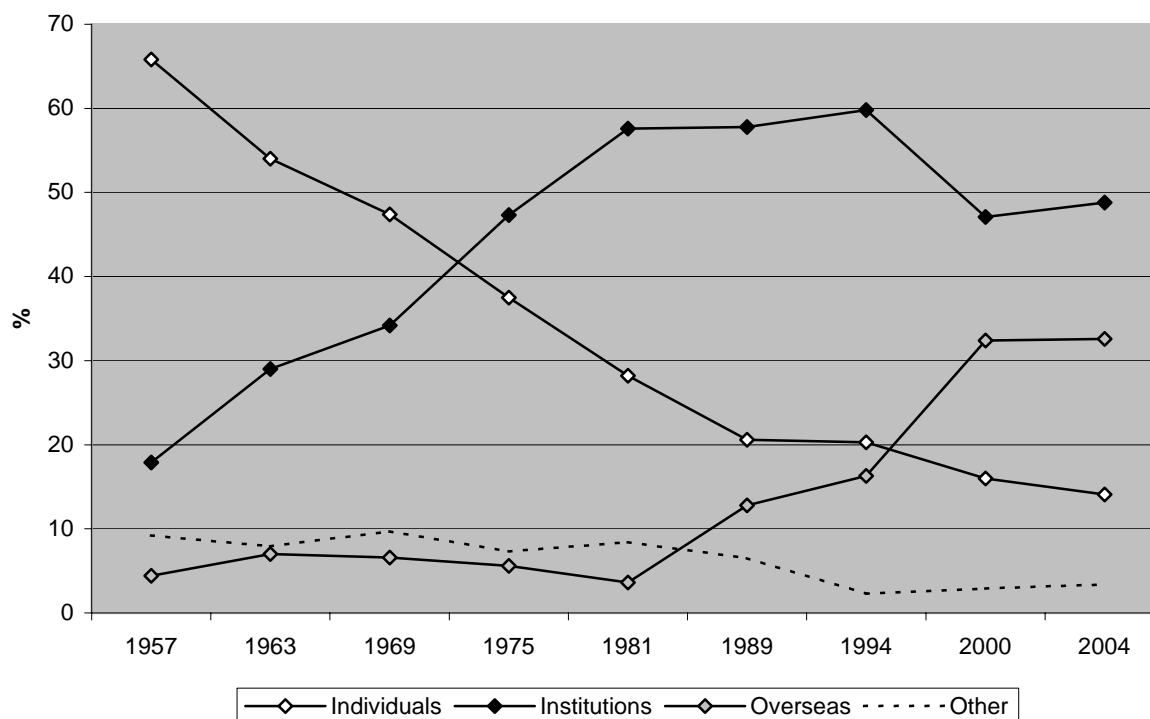
<sup>185</sup> See, e.g., Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, GEO. L.J. (1991); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. REV. 811 (1992).

<sup>186</sup> Sources: Benjamin M. Friedman, *Economic Implications of Changing Share Ownership*, 2 J. PORTFOLIO MANAG. 59, \_\_ (1996); BOARD OF GOVERNORS OF THE FEDERAL RESERVE, *FLOW OF FUNDS ACCOUNTS IN THE UNITED STATES, 1995-2005*, at 82 (2006) (Table L.213: Corporate Equities).

<sup>187</sup> See [Cheffins paper—reference to follow]

important.

**Figure 2: Share ownership patterns in the UK, 1957-2004<sup>188</sup>**



The first, and probably most important, factor, was the punitively high rates of marginal taxation applied to investment income for individuals from the end World War II until 1979: the top marginal rate was 90% for most of this period, rising to 98% from 1974-79.<sup>189</sup> Secondly, tax relief was at the same time accorded to collective investment schemes. The most extensive was that granted to pension funds, which were entirely exempt from tax on dividend income, part and parcel of the UK's favorable tax environment for private pension plans.<sup>190</sup>

<sup>188</sup> Sources: OFFICE FOR NATIONAL STATISTICS, SHARE OWNERSHIP REPORT 2004 (2005); John Moyle, *The Pattern of Ordinary Share Ownership, 1957-1970*, University of Cambridge Department of Applied Economics Occasional Paper No 31 (1971).

<sup>189</sup> See, e.g., Tom Clark & Andrew Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note No 25, at 7-8 (2002), available at <http://www.ifs.org.uk/bns/bn25.pdf>. Under the Thatcher government, the top marginal rate was lowered to 60% in 1979 and then to 40% in 1988 (*id.*).

<sup>190</sup> See Leslie Hannah, *Why Employer-Based Pension Plans? The Case of Britain*, 45 J. ECON. HIST. 347, 354 (1985); HM TREASURY, *THE MYNERS REVIEW OF INSTITUTIONAL INVESTMENT IN THE UK ("MYNERS REVIEW")*, at 29 (2001) (available at <http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf>).



However, insurance companies also enjoyed a favorably low rate of tax on dividend income.<sup>191</sup> Together, these factors exerted a pressure away from individual and towards collective ownership of shares.<sup>192</sup> As executors of the estates of those who held large stock portfolios sold shares, for instance, hefty income taxation on dividends for individuals coupled with tax breaks for collective investments meant that the buyers of these shares tended to be institutions.<sup>193</sup>

As Figure 2 shows, institutional investors first started to accumulate significant proportions of shares in British companies in the mid-1950s. By the mid-1960s, they were firmly established at the heart of UK corporate governance.<sup>194</sup> Their ownership continued to rise until the early 1990s. For the whole of this period, the institutions have been a catalyst for developments in UK corporate governance.

As collective investors, it might be thought that institutions are able to overcome the free-rider problems that besets individual shareholders in disciplining corporate management. Yet British institutional investors have long been notoriously passive as regards the performance of individual companies, preferring, in the terminology popularized by Albert Hirschman, “exit” to “voice”<sup>195</sup> (that is, selling their shares rather than getting involved in putting pressure on management).<sup>196</sup> Policy-makers periodically debate possible techniques to encourage—or compel—institutions to take a greater interest in

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<sup>191</sup> *Shareholders: Why So Few?*, ECONOMIST, July 2, 1966, at 52.

<sup>192</sup> It is sometimes suggested that high rates of postwar inflation contributed to institutional investors’ preference for equities, as opposed to fixed-income securities (*see, e.g.*, MYNERS REVIEW, *supra* note 190, at 32). While this undoubtedly led institutions to favour shares over fixed-income investments, it would have had a similar impact on all investors, and so does not fully explain why institutions’ stock holdings increased *relative to individuals*.

<sup>193</sup> Jack Revell, *Who is Selling Shares?*, THE TIMES, November 24, 1964, at 18 (report of survey of shares sold during 1963: many shares sold on death of individuals; most purchased by institutions).

<sup>194</sup> *See, e.g.*, *Equity Investment and its Responsibilities*, ECONOMIST, July 4, 1964, at 75, 75 (“Collectively these bodies have a power to influence boards of directors that a large number of small investors can never have”).

<sup>195</sup> ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* (1970).

<sup>196</sup> *See, e.g.*, Paul L. Davies, *Institutional Investors in the United Kingdom*, in *CONTEMPORARY ISSUES IN CORPORATE GOVERNANCE* (D.D. PRENTICE AND P.R.J. HOLLAND, EDS.), 69 at 89-90 (1993); Black & Coffee, *supra* note 6, at 2055-2073; JOHNATHAN CHARKHAM & ANNE SIMPSON, *FAIR SHARES*, at 137-139, 171-173 (1999).

the firms in which they invest.<sup>197</sup> Yet a relatively large block must be held for free-rider problems to be overcome as respects individual companies. Most institutions hold diversified portfolios, and so their stakes in individual companies tend to be proportionately small,<sup>198</sup> and co-ordination between them is costly. Whilst some intervention does occur “behind the scenes,” it tends to occur only *in extremis*.<sup>199</sup> In most cases, though, the game is just not worth the candle.

The way in which institutional investors have made a difference to UK corporate governance has, in contrast, been through their influence on rule-making—that is, the formation of formal and informal norms that govern the operation of corporate enterprise.<sup>200</sup> In a range of different contexts—including the strengthening of pre-emption rights,<sup>201</sup> the disuse of non-voting shares and other embedded takeover defenses,<sup>202</sup> the strengthening of Listing Rules requiring shareholder consent for major corporate transactions,<sup>203</sup> and the introduction of the Combined Code on Corporate Governance (dealing with issues of board structure, tenure and compensation),<sup>204</sup> UK institutional investors have been active either in lobbying regulators or in seeding market norms.

To be sure, free-rider effects are present in lobbying and rule-making activity too. But two factors make this a more effective means of intervention than attempts to improve individual companies’ governance. First, while exit is a

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<sup>197</sup> See, e.g., SIR ADRIAN CADBURY, REPORT OF THE COMMITTEE ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (“THE CADBURY REPORT”), at ¶¶ 6.9-6.15 (1992) (available at <http://rru.worldbank.org/Documents/PapersLinks/1253.pdf>); MYNERS REVIEW, *supra* note 190, at 89-94.

<sup>198</sup> See Marc Goergen & Luc Renneboog, *Strong Managers and Passive Institutional Investors in the UK*, in THE CONTROL OF CORPORATE EUROPE (FABRIZIO BARCA & MARCO BECHT EDS., 2001), 259 at 268-270 (median block held by largest shareholder in UK listed companies approximately 10% of voting rights).

<sup>199</sup> See EILÍS FERRAN, COMPANY LAW AND CORPORATE FINANCE, 271-272 (1999); see also sources cited *supra* note 196.

<sup>200</sup> See generally Black and Coffee, *supra* note 6, at 2034-2055; STAPLEDON, *supra* note 23, 56-77.

<sup>201</sup> See *supra*, note 25 and text thereto.

<sup>202</sup> See *supra*, notes 22-24 and text thereto.

<sup>203</sup> The UK Listing Rules require a shareholder vote to approve “Class 1” transactions, namely those of a value more than 25% of a company’s gross assets or profits (UK LISTING RULES, Rule 10). These rules were strengthened following institutional investor lobbying of the London Stock Exchange (then responsible for writing them) in 1978: see STAPLEDON, *supra* note 23, at 60.

<sup>204</sup> STAPLEDON, *supra* note 23, at 67-77.

rational strategy with particular investments, it is not with respect to market-wide rules. Hence the choice is simply between intervention and free-riding. Exerting influence over the content of corporate governance rules may yield positive returns, even in the presence of free-riding activity. Secondly, given that they cannot easily exit the market, each institution recognizes that if it is not involved in influencing a change, others might do so in a way that harms its interests. Hence the observed strategy for was one of co-ordinated lobbying for rules that were expected to maximize the joint welfare of institutional investors. The Takeover Code is a good example. Institutional investors were involved at every stage of the drafting of the Code, right from its beginnings as the *Notes*. Because institutional investors have a clear interest in rules which maximize expected gains to shareholders, it is not surprising that the emergence of a pro-shareholder approach to takeover regulation should have coincided with the emergence of institutional investors as a significant force in British share ownership.

UK institutional investors were, in fact, able to go one better than lobbying for their desired rules. They were in many cases able to pre-empt public regulation entirely by taking charge of enforcement, too.<sup>205</sup> Enforcement of private rules is feasible in an environment where parties interact repeatedly, as UK institutional investors do within the “Square Mile” of the City of London.<sup>206</sup> As repeat players, the institutions were able to agree on a mode of takeover regulation that was much cheaper than litigation, and to threaten reputational sanctions—exclusion from the market—against those who refused to comply with the Code and/or Panel rulings. However, as we have seen, the process of establishing the

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<sup>205</sup> This, of course, also made it easier for the institutions to influence the content of the regulations.

<sup>206</sup> It is one of the “folk theorems” of game theory that in the context of an indefinitely repeated game, there are multiple possible equilibria, some of which will induce co-operative behavior in individual rounds. *See, e.g.* DOUGLAS G. BAIRD, ROBERT H. GERTNER & RANDALL C. PICKER, *GAME THEORY AND THE LAW*, at 172-173 (1994); ERIC RASMUSEN, *GAMES AND INFORMATION*, at 123-126 (2<sup>nd</sup> ed. 1994). Where the parties can communicate with one another, then it is possible for them to co-ordinate on an equilibrium, and they may be expected to select on that is joint welfare enhancing: *see, e.g.*, ROBERT ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBOURS SETTLE DISPUTES*, 167-183 (1991). This is supported by studies of the norms governing close communities of commercial actors: *see, e.g.*, Avner Greif, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders*, 44 J. ECON. HIST. 857 (1989) (eleventh-century Maghribi traders); ELLICKSON at 184-206 (cattle ranchers in Shasta County, California, and eighteenth-century New England whalers); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001) (contemporary cotton industry participants); John Armour & Simon Deakin, *Norms in Private Insolvency: The “London Approach” to the Resolution of Financial Distress*, 1 J. CORP. L. STUD. 21 (2001) (banks involved in debt restructurings in City of London); Gillian K. Hadfield, *Delivering Legality on the Internet: Developing Principles for the Private Provision of Commercial Law*, 6 AM. L. & ECON. REV. 154 (2004) (detailing mechanisms for creation of reputations by internet traders).

Panel's enforcement procedures needed a kick-start, in the form of a credible threat of government intervention.

A reader more familiar with the US story might ask why British managers were so quiet in all of this. Why did they not lobby politicians for more pro-management rules, or push for more active representation in the Working Parties that were responsible for writing first the *Notes* and then the Code? To be sure, the first wave of hostile takeovers in the early 1950s provoked public hostility from corporate managers and trade unions, who denounced individuals like Clore and Samuel as “speculators” intent on the “predatory dismembering” of British businesses solely to “tak[e] out as much cash as possible in the shortest time.”<sup>207</sup> Moreover, at this time, institutional investors would have been a much less powerful force. Yet the close links between the government and the Bank of England, on the one hand, and the Bank and City institutions on the other, meant that City voices would have been loud advocates, in Ministers' ears, for non-interventionist solutions. Furthermore, while a good number of politicians—particularly in the Labour party—sympathized with the popular caricature of the bidder as “asset stripper” and were in pro-intervention, the Labour party's strongly pro-union policies and penchant for nationalization would have led managers to think twice before inviting greater regulation of their affairs from this quarter.

Although managers of listed companies must have felt threatened by the advent of the hostile takeover, they would at the outset have felt that they had powerful allies in the form of the “blue-blood” merchant bankers, to whom their goodwill was important as underwriting clients. It seems that managers' initial tactic was to try, in alliance with this group of bankers, to establish a norm that hostile bids were illegitimate. This came to be pitted against the growing force of institutional investors in the battle for British Aluminium, an episode that also explains how the institutions took control of the rule-creation process regarding takeovers.

In 1958, it will be recalled,<sup>208</sup> the BA board had tried to present its shareholders with a *fait accompli* in the form of a deal with Alcoa, so as to preclude a bid by TI-Reynolds. Shortly after the BA board revealed the Alcoa deal, a group of institutions with large holdings in BA met to discuss their concerns. They resolved, in what was the first public statement along the lines of the board neutrality rule, that it was inappropriate for directors to take steps that would materially affect control of a company—such as issuing large blocks of unissued

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<sup>207</sup> See, e.g., *The Shareholder Today*, *ECONOMIST*, December 19, 1953, 903 at 903-905.

<sup>208</sup> See *supra*, text to notes 129-133.

shares—without shareholder approval.<sup>209</sup> The significance of this is borne out by a comment from *The Times*:<sup>210</sup>

It is easy to understand why both sides should be anxious to put their views before the institutions. First, it is often left to the institutions to take a view on behalf of the equity holders as a whole; in a complex case of this kind the institutions often become in effect spokesmen for all the shareholders. Secondly, ... the institutions have a large interest [over 10%] in British Aluminium's Ordinary share capital, so that their votes—as well as their example—must have an important effect on the final result.

So influential were the institutional shareholders becoming that their vigorous condemnation of the BA board's tactics had the immediate effect of eliciting statements from several other companies that they proposed in future not to issue significant blocks of stock without shareholders' consent.<sup>211</sup>

The BA board marshaled its establishment allies to fight back. Its merchant bankers, Hambros and Lazards, were two of the oldest and most “blue blooded” houses.<sup>212</sup> Together, they persuaded a consortium of leading old-school banks and institutions to enter the fray on BA's behalf, openly seeking to influence the outcome of the dispute, and presumably to set a precedent.<sup>213</sup> On New Year's Eve in 1958, in the height of the takeover battle, a syndicate of fourteen City institutions, led Hambros and Lazards, announced an offer to buy half of any holdings in BA on the condition that investors retain the other half until the TI-Reynolds bid had lapsed.<sup>214</sup> They claimed to have the backing, in secret, of

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<sup>209</sup> *No Early Move on Aluminium*, THE TIMES, December 5, 1958, at 12; *No Early Official Decision on British Aluminium*, THE TIMES, December 5, 1958, at 19.

<sup>210</sup> *T.I. to Meet the Institutions*, THE TIMES, 10 December, 1958, at 16.

<sup>211</sup> *British Aluminium Reply*, THE TIMES, 16 December, 1958, at 12.

<sup>212</sup> See JOSEPH WECHSBERG, *THE MERCHANT BANKERS 72-74* (1967); DAVID FARRER, *THE WARBURGS 180-181* (1975); RON CHERNOW, *THE WARBURGS: A FAMILY SAGA 648-649* (1993).

<sup>213</sup> A precedent may already have existed. There is some suggestion that a similar sort of tactic was used, far more discreetly, in the Savoy Hotel battle six years earlier (discussed *supra*, text to notes 122-128) to buy off the hostile bidder. See BULL & VICE, *supra* note 118, at 59.

<sup>214</sup> *New Move in Battle for British Aluminium*, THE TIMES, 31 December 1958, at 13; *Cash Bid for Aluminium: Intervention by City Group*, THE TIMES, January 1, 1959, at 8; *British Aluminium: Long Knives Out*, ECONOMIST, January 3, 1959, at 62. The syndicate also comprised Lonsdale & Co, the British South Africa Company, Brown, Shipley & Co, Cables Investment Trust, Robert Fleming, Guinness, Mahon & Co, the Locana Corporation, Samuel Montagu, Morgan Grenfell, M. Samuel & Co, Edward de Stein & Co and the Whitehall Trust (*id.*)

“many large banking institutions and financial concerns,”<sup>215</sup> and to have received assurances from the holders of about 20 per cent of BA’s stock that they would not accept the TI-Reynolds bid.<sup>216</sup> The syndicate urged shareholders—and in particular, institutional investors—to support their cause on grounds of “national interest,” alleging that the Alcoa deal was the only way that BA could remain in British hands.<sup>217</sup>

The syndicate’s offer led to an outbreak of open sparring within the normally closed ranks of the City’s banking community. It appeared to many that the old-school merchant banks were flexing their muscles in an unseemly fashion in order to protect the perceived interests of their clients—the BA managers.<sup>218</sup> Those same managers, in the eyes of many institutional investors, had acted in disregard of the shareholders’ interests. TI and Reynolds were advised by Helbert Wagg and S.G. Warburg & Co. The latter had been recently founded by Siegmund Warburg, one of the few merchant bankers of the time willing to dirty his hands with hostile bids, and regarded by many in the City’s establishment as an upstart arriviste.<sup>219</sup> His clients responded aggressively to the syndicate’s offer: they upped their bid whilst at the same time buying BA’s shares vigorously in the market.<sup>220</sup> Institutional shareholders sold to them *en masse*. The whole affair was a very public and expensive humiliation for the members of the City syndicate, who found themselves minority stockholders in a business controlled by TI-Reynolds.

The battle for British Aluminium defused any willingness in the City’s old guard to push a pro-management agenda. The obvious lesson that the syndicate’s opposition had been an expensive mistake would have been coupled with the forceful realization that the institutional shareholders were now a force to be reckoned with. Institutions’ fiduciary duties to their beneficiaries meant that

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<sup>215</sup> *Letters to the Editor*, THE TIMES, January 12, 1959, at 9 (Letter from Mr Olaf Hambro, chairman of Hambros Bank, about the affair).

<sup>216</sup> *City Group’s Scheme for British Aluminium*, THE TIMES, January 1, 1959, at 13.

<sup>217</sup> *Cash Bid for Aluminium: Intervention by City Group*, THE TIMES, January 1, 1959, at 8.

<sup>218</sup> *War to What Purpose?*, ECONOMIST, January 10, 1959, 145 at 147; STAMP & MARLEY, *supra* note 115, at 7-8.

<sup>219</sup> See FARRER, *supra* note 212, at 181 (“unloved and unknown”); CHERNOW, *supra* note 212, at 647 (“arriviste and enfant terrible”).

<sup>220</sup> *New Phase in the British Aluminium Dispute: Moves at Bank of England*, THE TIMES, January 2, 1959, 12; *T.I.-Reynolds own Third of British Aluminium*, THE TIMES, January 3, 1959, at 11; *Tube Investments Add £2,250,000 to Aluminium Shares Offer*, THE TIMES, January 5, 1959, 8; *Reynolds Buys More British Aluminium Shares*, THE TIMES, January 6, 1959, at 8.

they were much more likely just to “follow the money” than wealthy individual shareholders, who might be subject to persuasion by establishment links.<sup>221</sup> Merchant banks that had previously adopted a pro-management stance might have had cause to reflect on the increasing importance to their underwriting business of good relations with institutions, and realized that indeed there was much to be lost through antagonizing them.<sup>222</sup> Moreover, there was plenty of money to be made through advising on acquisitions.

The institutional shareholders capitalized on the moral advantage given to them by the BA affair by seeking to crystallize the norm of board neutrality. A statement was issued by the Association of Investment Trusts, with the support of the British Insurance Association, that in their view “it is wrong for directors to allow any change in control or the nature of the business without referring to shareholders.”<sup>223</sup> *The Times* thought views were becoming sufficiently unified that it was possible to opine in the summer of 1959 that, “the broad code of business ethics applicable [to take-overs] will soon come to be generally recognized.”<sup>224</sup>

Shortly afterwards, when the Bank of England convened its Working Party for the drafting of the *Notes*, the groups represented were institutional investors, merchant banks and finance houses.<sup>225</sup> Neither of the major contemporary management organizations, the Institute of Directors or the Association of British Chambers of Commerce, was involved in the principal deliberations.<sup>226</sup> It seems most likely that this was simply because these were not “City” organizations, and so the Bank was unable to approach them informally and in secret. With any resistance from old-school merchant banks subdued, the institutions were able simply to translate their statement of policy, expressed in the heat of the British Aluminium battle, into the *Notes* that came to represent what was regarded as “fair play” in the conduct of takeover bids.

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<sup>221</sup> See BULL & VICE, *supra* note 118, at 65-66.

<sup>222</sup> See FARRER, *supra* note 212, at 181. The affair also sealed S.G. Warburg’s reputation as the pre-eminent advisor for hostile bidders: CHERNOW, *supra* note 212, at 653.

<sup>223</sup> *Consulting Shareholders: The Institutions’ Views*, THE TIMES, February 11, 1959, at 15.

<sup>224</sup> *Editorial: Top-hat take-overs*, THE TIMES, June 19, 1959, at 13.

<sup>225</sup> Those involved were the Issuing Houses Association, the Accepting Houses Committee, the Association of Investment Trusts, the British Insurance Association, the Committee of London Clearing Bankers and the London Stock Exchange. *Queensbury Rules for Bids*, ECONOMIST, October 31, 1959, at 440, 440.

<sup>226</sup> *Rules for Take-Overs?*, ECONOMIST, October 17, 1959, at 270. Both did, however, set up committees to coordinate their response to the issue of take-over bids: *Under Scrutiny*, ECONOMIST, October 24, 1959, at 358.

When the trade associations that had drafted the *Notes* were reconvened by the Bank of England nine years later for the Takeover Code, the Confederation of British Industry, another management organization, was invited to participate in the drafting process.<sup>227</sup> However, by then, management opposition to the idea of hostile takeovers had waned dramatically. Most bids in the 1960s were driven by consolidation, and managers were just as likely to be bidders as targets in this milieu.<sup>228</sup> No serious opposition has since been raised to the idea of the board neutrality rule.

### C) Legislation and Courts: The Case of the US

To understand why one finds neither institutional shareholders nor self-regulation at the heart of US takeover regulation, we should begin by revisiting the enactment of the securities acts of 1933 and 1934. The Securities Acts established a new system of disclosure and antifraud regulation, and for establishing the SEC to police the American securities markets. As an accidental consequence of the New Dealers' quite conscious housekeeping, the Securities Acts laid the groundwork for a judicial rather than self-regulatory mode of takeover regulation.

Until the 1930s, the nation's *de facto* market regulator was the New York Stock Exchange. "By 1934," Paul Mahoney has written, "the NYSE had for many years required listed companies to provide stockholders with a balance sheet and income statement in advance of each annual meeting. By 1928, the annual financial statements had to be audited by an independent auditor. Beginning in the early 1920s, the Exchange began to push for companies to agree to quarterly reporting, and such undertakings were already common in listing agreements by the mid-1920s."<sup>229</sup> Although the New York Stock Exchange was a private entity—a "private club" in William Douglas's dismissive term<sup>230</sup>—most of the nation's largest corporations were listed on the exchange. The NYSE listing

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<sup>227</sup> The Working Party for the *City Code* comprised the same institutions that had participated in the drafting of the *Notes*, with the addition of representatives of the National Association of Pension Funds and the Confederation of British Industry. See *Issuing Houses Prepare Code*, THE TIMES, July 22, 1967, at 15; TAKEOVER PANEL, REPORT FOR THE YEAR ENDED 31 MARCH 1969, at 2 (1969).

<sup>228</sup> See BULL & VICE, *supra* note 118, at 14.

<sup>229</sup> Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1466 (1997). For a much more critical account of NYSE self regulation, see Robert A. Prentice, *The Inevitability of a Strong SEC*, CORNELL L. REV. (2006).

<sup>230</sup> WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 65 (1940).



rules thus served as a form of industry self-regulation similar in many respects (though different in others, as we shall see)<sup>231</sup> to the current strategy for regulating takeovers in the UK.

The New Deal reformers believed that the NYSE's regulatory efforts were inadequate— that more disclosure was needed and that the NYSE too often looked the other way when companies failed to honor the existing rules (similar criticisms to those that would be laid against the first incarnation of the Takeover Panel in 1968).<sup>232</sup> Because of this, and as part of their larger campaign to minimize the influence of Wall Street insiders in American corporate governance, the reformers quite consciously wrested oversight authority away from the Exchange and enshrined it in the Securities Acts and the rules promulgated by the SEC. This meant that the primary source of securities regulation would be mandatory federal oversight by Congress and the SEC, rather than ongoing self-regulatory adjustments of the sort we see in the UK.<sup>233</sup>

The Securities Acts also had a subtler, geographical effect. One of the factors that have made self-regulation effective in the UK, as we have seen, is the fact that all of the major players are located in close proximity to one another in the City, London's ancient business district. This makes the temporary "secondments" used to staff the Panel much simpler than if the banks and institutions were scattered throughout the country, and it means that the bankers and institutional shareholders rub shoulders on a daily basis.

Although America's financial institutions have always been more widely flung than their UK counterparts, until the 1930s the largest players were concentrated on Wall Street. So long as stock exchange officials, J.P. Morgan and the other investment banks, and most of the largest shareholders all walked the same streets of lower Manhattan, it was conceivable that informal rules for takeovers might have developed in the 1950s or 1960s— or indeed, that lawmakers might have pressured shareholders and the exchanges to develop informal rules, as the

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<sup>231</sup> See *infra*, text to notes 263-266 (discussing limitations of NYSE as self regulator).

<sup>232</sup> See *supra*, notes 152-153 and text thereto.

<sup>233</sup> For a description of the powers the Securities Exchange Act of 1934 gave the SEC over the New York Stock Exchange and the other exchanges, see, e.g., Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. 79, 93 (2005)(describing power "to abrogate and amend [NYSE] rules," as well as additional powers given to the SEC in 1975). Interestingly, William Douglas favored direct, coerced self-regulation of US business under "a federal agency with the mandate to regulate large multinational corporations by directing their governance." *Id.* at 133. But Congress never established the additional agency he envisioned.

Bank of England did in the UK.<sup>234</sup> But the Securities Acts added Washington DC to the regulatory map, thus making it impossible to replicate the geographical proximity that characterizes corporate governance in the UK. In the US, visiting all of the relevant players would require trips to Wall Street, Washington and— because directors fiduciary duties are still regulated by the states— Wilmington and Dover, Delaware.

The lack of institutional investor influence in the US meant that although the emergence of hostile tender offers in the late 1950s took corporate America by storm, just as in the UK, the political and regulatory dynamics could not have been more different. When Senator Harrison introduced the legislation that eventually became the Williams Act in 1965, his principal concern wasn't the use of questionable defenses by target managers. It was “corporate raiders,” the “white collar pirates” that were assaulting “proud old companies” and stripping them down to “corporate shells” by “trad[ing] away the best assets” and keeping “the loot” for themselves.<sup>235</sup> Senator Williams candidly acknowledged his desire to assure that corporate managers had ample time to mobilize their opposition to a takeover threat. In a 1967 hearing on a revised version of the bill, Senator Kuchel, who co-sponsored the legislation with Senator Williams, sounded the same themes. “Today,” he complained, “there are those individuals in our financial community who seek to reduce our proudest businesses into nothing but corporate shells. They seize control of the corporation with unknown sources, sell or trade away the best assets, and later split up the remains among themselves.”<sup>236</sup> A favorite illustration of these dangers was a bid for Columbia Motion Pictures, “an organization renowned for its significant contribution to the entertainment industry.”<sup>237</sup> In late 1966, a French bank had made a tender offer for a sizeable minority stake of Columbia, allegedly as part of a plan to join forces with a group of dissident shareholders to take control. The French bank disguised both its identity and its intentions. “If this attempt had succeeded,” according to Senator Kutchel, “Columbia would have found itself under the control of a combination including significant foreign interests,

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<sup>234</sup> [Note that an informal “Gentleman’s Code” discouraged white shoe investment banks from participating in hostile takeovers in the US in the 1960s. This may suggest the importance of an external government prod, rather than self-regulation alone; it also reinforces the point that it’s important to have all of the shareholder groups at the table, not just one— the investment banks].

<sup>235</sup> 111 CONG. REC. 28,57-60 (remarks of Senator Williams), *quoted in* Note, *supra* note 103, at 381 n.28. *See also* Eileen Shanahan, *Senator Seeking Take-Over Curbs*, N.Y. TIMES, Oct. 25, 1965, at 57 (describing Williams’ bill as “designed to help prevent ‘corporate raiding’”).

<sup>236</sup> *Hearings Before the Subcommittee on Securities of the Committee on Banking and Currency on S. 510*, 90<sup>th</sup> Cong. 1<sup>st</sup> Sess., 43 [cited hereafter as *1967 Senate Hearing*](remarks of Senator Kuchel).

<sup>237</sup> *Id.*

without prior notice to the company, without an opportunity for examination into the circumstances surrounding the tender offer, and without any regard for the rights of its stockholders.”<sup>238</sup>

One might have expected the principal opposition to the proposed legislation to come from institutional shareholders such as pension funds and insurance companies whose stock holdings benefited from the premium prices paid by takeover bidders. Clamping down on tender offers would mean fewer takeover premia. But one searches the legislative history in vain for evidence that institutional shareholders entered the legislative fray. The SEC testified repeatedly, and indeed seems to have helped Senator Williams to shape the legislation. Representatives of the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers also testified, as did the Investment Bankers Association of America.<sup>239</sup> Even law and business professors testified.<sup>240</sup> But not one representative of a pension fund, insurance company or other institutional shareholder took the microphone to offer the perspective of shareholders on the proposed legislation.<sup>241</sup>

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<sup>238</sup> *Id.* “Fortunately,” Kuchel concluded, “the threat of takeover ... was resolved by a private agreement between the parties. But such agreements offer little assurance that similar future attempts at such secretive attempted takeovers will not succeed.” *Id.*

<sup>239</sup> The exchanges were generally sympathetic the legislation, but criticized the proposal for prior notification and suggested the shareholder withdrawal rights and right to pro rata treatment should be limited to the first ten days of an offer. *See, e.g.*, Testimony of Donald L. Calvin, Vice President, New York Stock Exchange, *1967 Senate Hearing, supra* note 236, at 73-77.

<sup>240</sup> All of the professors criticized the bill, and most argued that tender offers appeared to be beneficial and should be encouraged rather than chilled. *See, e.g.*, Testimony of Stanley A. Kaplan, Professor of Law, University of Chicago; Robert H. Mundheim, Professor of Law, University of Pennsylvania; William H. Painter, Professor of Law, University of Missouri at Kansas City, *1967 Senate Hearing, supra* note 236, at 114-128. A focal point of their testimony was a study of tender offers by Samuel Hays and Russell Taussig. Contrary to Senator William’s charges that raiders were denuding proud American companies, Hays and Taussig found that most bidders did not sell off major assets after an acquisition. Hays reported the findings to the committee, and his article was reprinted as an appendix. Testimony of Samuel L. Hays, III, *1967 Senate Hearing, supra* note 236, at 53. Samuel L. Hayes, III & Russell A. Taussig, *Tactics of Cash Takeover Bids—For Bidders, Incumbent Managements, and Shareholders*, HARV. BUS. REV., March/April, 1967 [check].

<sup>241</sup> Almost the only evidence of participation by banks or other institutions is a letter from the American Bankers Associations suggesting that the legislation be adjusted to make clear that banking regulators rather than the SEC over publicly held banks. Letter from American Bankers Association to Senator Harrison Williams, *1967 Senate Hearing, supra* note 236, at 238. A number of letters from corporate managers and business trade groups are reprinted in the appendix to the 1967 hearings, each applauding the decision to regulate takeover bidders. *See, e.g.*, Letter from American Society of Corporate Secretaries, Inc. to Committee on Banking and Currency, *1967 Senate Hearing, supra* note 236, at 238, 239 (stating that the “Society believes that the information requirements are both desirable and reasonable”); Letter from Holly Sugar Corp. to Senator Harrison Williams, *1967 Senate Hearing, supra* note 236, at 244 (stating that “in an industry charged with a responsibility for production and marketing of our nation’s sugar, not only the shareholders ... and the Securities and

Shareholders' silence surely reflected the fact that, during the same period as UK tax and dividend policy spurred institutional stock ownership, the share of US stock held by institutions remained relatively small. Shareholder voice may also have been chilled by the knowledge that American lawmakers historically got nervous when financial institutions flexed their muscles on corporate governance issues.<sup>242</sup>

As a result, the interests of shareholders were represented not by shareholders themselves, but by the SEC. The SEC's mantra throughout was "neutrality" between bidders and target managers. "[T]he principal point, as SEC Chairman Manuel Cohen put it, "is that we are not concerned with assisting or hurting either side. We are concerned with the investor who today is just a pawn in a form of industrial warfare. And that is all the argument today is: Do you help one side, or to you help the other side? The investor is lost somewhere in the middle. This is our concern and our only concern."<sup>243</sup>

As a result of the SEC's plea for a less lopsidedly antitakeover bill, Senator Williams adjusted his proposed the proposed legislation to shorten the pre-solicitation disclosure period to five days, and to give the SEC authority over target managers' missives against a takeover bid, as well as over the bidder's solicitations.<sup>244</sup> The SEC did not ask for, nor did it receive, more extensive powers to regulate takeovers, such as the power to assess the merits of a takeover bid.<sup>245</sup> This diffidence seems to have reflected a perception that the SEC's authority was limited to ensuring adequate disclosure and after-the-fact policing of fraud, another legacy of the New Deal package of reforms.<sup>246</sup> This

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Exchange Commission, but also the Federal Government agencies responsible for administering the Sugar Act should, at least, have the opportunity of learning the identities and intentions of outside groups that are seeking control of sugar producers").

<sup>242</sup> See, e.g., ROE, *supra* note 6.

<sup>243</sup> 1967 Senate Hearing, *supra* note 236, at 178 (remarks of Manuel Cohen).

<sup>244</sup> See, e.g., Note, *supra* note 103, at 381 n.28.

<sup>245</sup> The SEC's only request was that it be given "more flexible authority to administer" the provisions included in the proposed legislation. See, e.g., Eileen Shanahan, *S.E.C. Seeking Stock 'Warfare' Rules*, N.Y. TIMES, March 22, 1967, at 61 (describing Cohen testimony).

<sup>246</sup> Interestingly, the year after the Williams Act was enacted and Cohen had stepped down from the SEC, he characterized the Williams Act as "obsolete" and "inadequate," and argued that the SEC be given the authority to "set standards of conduct to regulate conglomerate financial statements and debt-to-equity ratios 'so that the [Commission] does not have to rely on proving a fraud after the event.'" SELIGMAN, *supra* note 100, at 432. Seligman suggests that these statements reflect Cohen's real views, views he was reluctant to express when he "had the burden of husbanding the

meant that all of the regulatory gaps would be left to common law development as part of the evolving law of directorial duties in the Delaware state courts.<sup>247</sup>

Because the self-regulatory option had long been foreclosed and the SEC's role was limited to policing disclosure, the most significant aspects of US takeover regulation are shaped by Delaware judges. As we shall see, this judicialization of US takeover regulation made it easier for a pro-manager approach to emerge. Judge-made law represents the accumulation of earlier precedents. However, the process of establishing precedents is necessarily reactive, rather than proactive, because judges can only decide cases which are brought before them. The structure of precedents may therefore be influenced by the ability or willingness of particular types of parties to litigate certain types of dispute.<sup>248</sup> The decision to litigate acts as a filter for the evolution of common law rules—or, to put it another way, it represents the “demand side” of common law judicial rule-making.<sup>249</sup>

As compared with less incremental modes of rule-making—such as legislation, or self-regulation, case law precedents are relatively free from interest group influences. An interest group wishing to change the law through litigation must not only agree on the preferred rule, but must also co-ordinate over time on choosing suitable test cases and in overcoming barriers to intervening in private disputes.<sup>250</sup> So it would have been more difficult for US institutional

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SEC's political resources [and] of speaking for his relatively more conservative fellow commissioners.” *Id.*

<sup>247</sup> We do not mean to suggest that that SEC regulation would have led to a truly pro-shareholder approach to takeover regulation. SEC regulation almost certainly would have chilled some takeovers, and the SEC's stance would have been linked more closely to political dynamics in Washington than to maximizing shareholder choice.

<sup>248</sup> For a review of the literature, see Paul H. Rubin, *Micro and Macro Legal Efficiency: Supply and Demand*, 13 SUP. ECON. REV. 19, 21-27 (2005).

<sup>249</sup> To be sure, in an environment characterized by regulatory competition, judges will have systematic incentives to favor parties who make the choice. Where the choice is made by both parties (e.g. contractual choice of law) then these incentives may be efficient. Where it is systematically made by one party (e.g. tort law) then the incentives will be inefficient: see Todd J. Zywicki, *The Rise and Fall of Efficiency in the Common Law: A Supply-Side Analysis*, 97 Nw. U.L. Rev. 1551 (2003). For the classic supply-side, interest group account of Delaware corporate law, see Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987). Bebchuk (*supra*, note 3) argues that a supply-side mechanism is primarily responsible for the manager friendliness of US takeover law as compared with its UK counterpart. In contrast, our explanation focuses on the demand side, and shows that in relation to the UK's *common law*, where similar demand-side circumstances prevail, the results are substantially similar to those in the US. See *infra*, text to notes 255-262.

<sup>250</sup> These include the rules on maintenance and champerty.

investors, even had they been as well-organized, to have influenced the production of takeover regulation by Delaware courts than it was for their UK counterparts to do so within a self-regulatory framework.

However, this is not to say that the production of judicial precedents is entirely free from bias towards private interests. To be sure, if all parties have equal access to funding, and equal likelihood of being involved in future litigation, inefficient rules may be expected to be litigated more frequently than efficient one, as they will impose greater costs on one or both parties.<sup>251</sup> Under such ideal circumstances, the common law would exhibit a tendency to evolve towards rules that promote social welfare. However, this optimistic assessment does not hold if one type of litigant has a systematically greater incentive or ability to litigate.<sup>252</sup> For example, a repeat player will be able to internalize the future benefits of a favorable precedent, and so will have a greater incentive to litigate than a one-shot player.<sup>253</sup> The characteristic difference of precedent from regulation or legislation, then, is not so much the absence of private interests, but the way in which these interests are mediated into the rule production process. The higher costs of co-ordinating to bring litigation—as compared to lobbying for legislative change—mean that for judge-made law, the interests of individual litigants (or populations of litigants) are relatively more important than those of co-ordinated groups for the production of rules.

Who, then, are the likely litigants in takeover disputes? The defendants will be the target board. Whilst protections such as D&O insurance and golden parachutes often counteract the financial risks, respectively, of personal liability and loss of employment, boards still face significant reputational costs (that is, depreciation of their human capital consequent upon defeat) if they lose a takeover lawsuit, which are far more difficult to insure. At the same time, because they are able to draw upon corporate resources, boards have deep pockets. This has two implications: first, that boards are likely to be willing to

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<sup>251</sup> See George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEG. STUD. 65 (1977); John C. Goodman, *An Economic Theory of the Evolution of the Common Law*, 7 J. LEG. STUD. 393 (1979); Avery Katz, *Judicial Decisionmaking and Litigation Expenditure*, 8 INT'L REV. L. & ECON. 127 (1988).

<sup>252</sup> Jack Hirschleifer, *Evolutionary Models in Economics and Law*, in 4 RESEARCH IN LAW AND ECONOMICS (PAUL H. RUBIN AND RICHARD ZERBE EDS., 1982), 1; Paul H. Rubin, *Common Law and Statute Law*, 11 J. LEG. STUD. 205 (1982); Martin J. Bailey & Paul H. Rubin, *A Positive Theory of Legal Change*, 14 INT'L REV. L. & ECON. 467 (1994). Similar results can follow where one group of litigants is systematically better informed about the likely outcome of litigation: See Keith N. Hylton, *Information, Litigation, and Common Law Evolution*, 8 AM. L. & ECON. REV. 33 (2006).

<sup>253</sup> Bailey and Rubin, *supra* note 252.

pay over the odds to settle cases; and secondly, that they will defend aggressively the cases that do go to trial. Whilst the target board can settle a stockholder suit for damages, they cannot do so easily where a jilted bidder seeks an injunction. Most precedents on target boards' duties have therefore resulted from cases where an injunction is sought.

The bidder's financial interest lies in the gains to be realized from successfully gaining control of the target company, which an injunction may achieve by forcing the target board to drop a defense. Yet an acquirer who succeeds in proving that the board's defensive tactics are illegitimate will not necessarily capture all of the economic benefits of the judicial ruling. There is nothing to stop a second bidder free-riding on the plaintiff's efforts and then swooping in on the now-defenseless target company with a higher offer. Given this possibility, the bidder will discount the likely benefits from bringing a lawsuit accordingly. This may be expected to result in under-investment in litigation effort by bidders. The resulting judge-made law may therefore exhibit inefficiency, in the sense that it is too pro-management.<sup>254</sup>

We should be clear that this analysis is not a criticism of Delaware law, or indeed of the civil procedure in the US more generally. Rather, it is a general proposition that follows from the use of common law adjudication to govern in this particular context. To see the generality of the point, we need only recross the Atlantic and consider the common law treatment of takeovers in the UK. As we have seen, judicial oversight of UK takeovers was sharply curtailed by the introduction of the Takeover Code in 1968. But the judicial precedents that had developed up to and shortly after that point bear a striking resemblance to several of the leading Delaware takeover decisions.

The UK common law position on takeover defenses was principally developed by a series of cases in the 1960s and early 1970s.<sup>255</sup> As in the US, most were actions by bidders seeking injunctions. They generally held that directors cannot take actions that have the primary purpose of preserving their own control of the company, or of altering the balance of power in the shareholders' meeting.<sup>256</sup>

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<sup>254</sup> John Coffee has made a similar claim about the substance of judge-made law in relation to takeover disputes, but based on a different mechanism. Coffee argues that judicial precedents will exhibit a pro-management bias owing to judges' unwillingness to impose multi-million dollar liabilities on directors where their conduct is not morally reprehensible: see Coffee, *supra* note 9, at 1150; John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Reform*, 81 COLUM. L. REV. 261, 316-18 (1981).

<sup>255</sup> *Hogg v. Cramphorn* [1967] Ch 254; *Bamford v. Bamford* [1970] Ch 212; *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] AC 821 (a case relating to facts occurring in Australia and heard in the UK before the Privy Council, then the highest court of appeal in that jurisdiction).

<sup>256</sup> *Howard Smith*, *supra* n 255, at 834-838.

Yet the jurisprudence also made clear that actions that were motivated primarily by a legitimate business purpose, and had a merely incidental effect of frustrating a bid, would not constitute a breach of duty.<sup>257</sup> In interpreting these statements, it is worth bearing in mind that the facts in the litigated cases were quite extreme. Most involved the issue of fresh shares to dilute the holding of an acquirer *after* voting control of the target had been secured (which would surely be a breach of duty under Delaware law too).<sup>258</sup> Had the directors acted with greater alacrity, before the bidder had secured control, it would have been more difficult to argue that they were interfering with the control of the general meeting. This would be particularly so if they formed the opinion, and could point to supporting evidence, that the bidder's plans for their company were not in its interests. Sir Robert Megarry, VC made this point expressly in the later case of *Cayne v. Global Natural Resources plc*:

If company A and company B are in business competition, and company A acquires a large holding of shares in company B with the object of running company B down so as to lessen its competition, I would have thought that the directors of company B might well come to the honest conclusion that it was contrary to the best interests of company B to allow company A to effect its purpose, and that in fact this would be so. If, then, the directors issue further shares in company B in order to maintain their control of company B for the purpose of defeating company A's plans and continuing company B in competition with company A. I cannot see why that should not be a perfectly proper exercise of the fiduciary powers of the directors of company B. The object is not to retain control as such, but to prevent company B from being reduced to impotence and beggary, and the only means available to the directors for achieving this purpose is to retain control. This is quite different from

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<sup>257</sup> Two Commonwealth decisions were cited by the Privy Council in *Howard Smith* as examples: see *Harlowe Nominees Pty Ltd v. Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 (High Court of Australia) (primary purpose of issuing shares was business purpose of raising capital: legitimate notwithstanding it had necessary effect of diluting hostile acquirer's holding); *Teck Corporation v. Millar* (1972) 33 DLR (3d) 288 (Supreme Court of British Columbia) ("lock-up" deal involving issue of shares to counterparty found to have been effected with primary purpose of securing for company most favorable terms for deal and therefore legitimate, notwithstanding that it had the necessary consequence of frustrating hostile acquisition).

<sup>258</sup> In Delaware, analogous maneuvers have long been struck down under a series of cases prohibiting managers from interfering with insurgents' voting rights. See, e.g., *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003)(managers increased board size to impede shareholder vote); *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 551 (Del. Ch. 1988)(same); *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (1971)(shareholder meeting date moved up to interfere with vote).



directors seeking to retain control because they think that they are better directors than their rivals would be ...<sup>259</sup>

This formulation does not seem substantially different to the “just say no” defense that some observers believe has been accorded to directors under Delaware law since *Time Warner*.<sup>260</sup>

These issues were recently considered again by the English Court of Appeal in the context of a very onerous lock-up agreement.<sup>261</sup> Carnwath LJ, who gave the leading judgment, suggested that a lock-up might be justifiable in the face of a hostile acquirer who threatened the company’s existing business, but felt that the arrangement in question was disproportionate in its response to the perceived threat: it took effect not just in relation to the particular bidder, but in relation to any change in the management of the company.<sup>262</sup> In other words, it smacked of entrenchment. This formulation is strikingly similar to the proportionality test employed by Delaware courts in reviewing directors’ conduct under *Unocal*.

Given that using litigation to resolve such matters involves a structural bias in favor of the directors, it should not be surprising that UK institutional investors chose to “privatize” the matter by instituting the Takeover Code in the late 60s. What is more surprising, however, is that their counterparts in the US did not. This, as we have explained, is a result of federal legislation which prevented institutional investors from developing sufficiently close links with one another to make collective action on this scale feasible in the US, together with federal regulation that displaced an earlier tradition of self regulation in the securities markets. There is an irony, therefore, in calls for federal legislation to remedy the perceived “problem” of Delaware takeover law: in our view, it is federal legislation that is fundamentally responsible for the perceived problem.

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<sup>259</sup> Unreported (1982), cited at first instance by Hart J in *Criterion Properties plc v. Stratford UK Properties LLC* [2002] 2 BCLC 151, 162-3.

<sup>260</sup> See Paul L. Davies, *The Regulation of Defensive Tactics in the United Kingdom and the United States*, in Klaus Hopt & Eddy Wymeersch (eds.), *EUROPEAN TAKEOVERS: LAW AND PRACTICE* 195, 207-210 (1992); Blanaid Clarke, *Regulating Poison Pills*, 4 J. CORP. L. STUD. 51, 61-67 (2004).

<sup>261</sup> It was referred to in the case as a “poison pill,” but in form it was closer to the arrangements known as “lock-ups” in the US.

<sup>262</sup> *Criterion Properties plc v. Stratford UK Properties LLC* [2002] EWCA Civ 1783, [2003] 1 WLR 2108 at [26]. The case was appealed to the House of Lords who decided it on different grounds: [2004] UKHL 28, [2004] 1 WLR 1846.

## V. LESSONS AND IMPLICATIONS

Our analysis has shown that the starkly different approaches to takeover regulation in the US and UK have been influenced by their characteristic modes of rule-production: courts have been the principal regulators in the US, where self-regulation shaped by institutional shareholders prevails in the UK. In each case, the regulatory mode was the largely unintended consequence of regulation designed to achieve other objectives. In the US, the securities laws displaced existing self-regulation and financial services legislation curbed institutional ownership of stock. In the UK, a postwar tax environment that favored collective, over individual, shareholding, coupled with a political toleration of self-regulation thrust institutions in the center of corporate governance.

In this part, we consider two questions that emerge from our historical and institutional analysis. First, do our findings suggest that self-regulation is generally preferable to judicial or regulator oversight? Second, what are the future prospects for the UK and US regimes? Does the increasing ownership of UK stock by non-British investors and the advent of the EU's Takeover Directive call into question the future of the Panel's oversight? At the same time, does the recent rise to prominence of institutional shareholders in the US mean that a more shareholder-oriented regime is likely to emerge here?

### A. The Choice Between Self-Regulation and Other Regulatory Strategies

Given the efficacy of the Takeover Code, it may be tempting to conclude that self-regulation is always an optimal regulatory strategy. But this would be a mistake. The effectiveness of self-regulation is closely tied to the incentives of the individuals and entities that are providing the rules. If the regulators' incentives are consistent with social welfare, self-regulation can work extremely well—and indeed, in an area characterized by rapid change, may prove far superior to legislative or judicial oversight. If their incentives diverge, on the other hand, self-regulation is much less attractive.

Two examples from the corporate and securities law context will make these intuitions more concrete. The first involves the US stock exchanges, which are treated as self-regulatory organizations under the US securities laws. As discussed earlier, until the 1930s, rules written by the New York Stock Exchange were the principal source of US securities regulation.<sup>263</sup> The brokers

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<sup>263</sup> See *supra*, text to notes 229-233.

and dealers who ran the exchange had an obvious interest in a vibrant securities market, since this strengthened the exchange and maximized their trading opportunities. But their incentives were, at best, imperfectly congruent with the objective of assuring vigorous, efficient corporate governance. Even under the post-New Deal structure, which shifted control from traders and specialists to member-brokers, the NYSE's self-regulatory incentives are a very noisy proxy for the best interests of the shareholders of listing companies.<sup>264</sup> Brokers may have an interest in chilling takeovers if the target is listed on the exchange, even if takeovers are generally efficient, since the takeover may mean one less company listed on the exchange.<sup>265</sup> The NYSE and other exchanges also have a strong interest in keeping important listed firms happy, even if the firm's happiness comes at the expense of effective corporate governance. The NYSE was famously unwilling to stand up to GM, for instance, when GM threatened to bolt if the NYSE tried to prohibit the use of stock with differential voting rights.<sup>266</sup>

Second, recent concerns about the misbehavior of hedge funds have prompted a wide-ranging debate about whether reform is necessary, and, if so, what shape the reform should take.<sup>267</sup> One proposal calls for the SEC to pressure the hedge fund industry to devise a set of "best practices" designed "to reduce the incident of fraud through establishing a custom of greater disclosure and transparency to investors."<sup>268</sup> While the threat of more sweeping federal regulation has indeed

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<sup>264</sup> Until it was forced by the New Deal SEC to reform its governance structure, the NYSE "was dominated by floor traders and specialists who traded largely for their own accounts." SELIGMAN, *supra* note 100, at 166. Since traders and specialists profit from buying and selling stock as part of their responsibility for assuring continuous, liquid trading, they might actually prefer an inadequate level of corporate disclosure; the opacity could enhance the importance of their role and create more opportunities for profitable trading.

<sup>265</sup> Brokers have an even more direct interest in their own fees. The NYSE imposed monopoly, fixed rate pricing on brokers' fee until 1975, when the SEC forced the NYSE to eliminate the requirement, a development known as the "Big Bang." *See, e.g.,* SKEEL, *supra* note 59, at 169 (describing Big Bang).

<sup>266</sup> *See, e.g.,* Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation: A Comment on Mahoney*, 83 VA. L. REV. 1509 (1997) (discussing the GM standoff). The stock exchanges' reluctance to impose discipline has magnified by the increasing competition among exchanges. In the early twentieth century, when a US company that wished to be publicly traded needed to list on the NYSE, the threat of delisting was a powerful stick. Now, a company could respond by simply listing on another exchange.

<sup>267</sup> In 2005, the SEC promulgated a rule that required most hedge fund advisors to register with the SEC by February 2006. *See, e.g.,* Gregory Zuckerman, *Hedge Funds Brace for Regulation*, WALL ST. J., June 8, 2005, at C1. The rule was recently struck down by the DC Circuit, and it is unclear whether the SEC will try to regulate in other ways in the absence of explicit authority from Congress.

<sup>268</sup> Erik J. Gruepner, *Hedge Funds are Headed Down-maker: A Call for Increased Regulation?*, Comment, 40 SAN DIEGO L. REV. 1555, 1596 (2003).

prompted a newfound interest within the hedge fund industry to provide meaningful information to potential investors,<sup>269</sup> the hedge funds' incentives to self regulate seem poorly aligned with the best interests of ordinary investors. Some of the strategies used by hedge funds are beneficial to the market– hedge fund arbitrage improves liquidity and the accuracy of market pricing, for instance– but hedge funds also benefit from strategies (such as the late trading and market timing practices that gave rise to the recent mutual fund scandals) that divert value from other investors. Under these conditions, proposals for self-regulation by the industry itself as a substitute for formal regulation need to be viewed with caution.

The incentives of the institutional investors and banks that oversee UK takeover regulation are not perfect, either. Institutional shareholders are, as the name suggests, institutions rather than private individuals. Like the companies they invest in and monitor, the decisions of institutional shareholders are made by agents whose own incentives may be skewed in various ways. They may be affected by political considerations rather than purely economic ones, for instance.<sup>270</sup> But overall, institutional shareholders are likely to focus on the overall profitability of the companies whose shares they hold. A regulatory framework that relies on ongoing regulation by these well-established market players, rather than on mandatory rules and judicial oversight, is likely to exhibit precisely the qualities we have seen in this part: speed, certainty and an emphasis on promoting the interests of shareholders.

## B. Will the UK's Takeover Code Endure?

As we have seen, the geographic and social homogeneity of the City of London played an important role in both the formation of the Takeover Code and the enforcement of the Takeover Panel's rulings. However, there has in recent years been a dramatic growth in overseas ownership of UK shares, as Figure 2 illustrates.<sup>271</sup> Much of this can be attributed to hedge fund activity, largely US-

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<sup>269</sup> See, e.g., *id.* At 1595 (“The hedge fund industry has already demonstrated its desire to prove that it does not need increased regulation through distributing best practices recommendations.”)

<sup>270</sup> Institutional shareholder conflicts of interest are explored in detail in Jill E. Fisch, *Relationship Investing: Will it Happen? Will it Work?*, 55 OHIO St. L. J. 1009 (1994); Rock, *supra* note 185. The other participants in the Takeover Code process also have imperfect incentives. The London Stock Exchange, for instance, has the same incentive to chill takeovers as just described with the New York Stock Exchange.

<sup>271</sup> See *supra*, text to note 188.

driven.<sup>272</sup> Overseas investors are likely to be less willing to follow local norms, raising the prospect of difficulties enforcing the Code.<sup>273</sup> However, a traditional strength of the Panel's enforcement technique has been its ability to impose sanctions on gatekeepers. The cooperation of trade associations meant that no professionals working in London's financial markets would be willing to advise a defaulting party.

Moreover, the Panel's enforcement powers have recently been strengthened as a result of the UK implementation of the EU's Takeover Directive.<sup>274</sup> The Directive, which was held up for many years by disputes over the treatment of employees,<sup>275</sup> takes as its starting point many aspects of the British model of takeover regulation, both as to substance (the board neutrality rule and the mandatory bid rule) and as to procedure (oversight of takeovers to be through a regulator rather than courts).<sup>276</sup> It also contains a provision—the so-called “breakthrough rule”—designed to neutralize certain embedded defenses based on differential voting rights.<sup>277</sup> However, the board neutrality and breakthrough

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<sup>272</sup> See, e.g., European Commission, Report of the Alternative Investment Expert Group: Managing, Servicing and Marketing Hedge Funds in Europe, 13 (2006) (detailing US contribution to world hedge fund industry).

<sup>273</sup> To be sure, there have been various instances in the Panel's history where individuals overseas have disobeyed its rulings with seeming impunity. One example was the Panel's ruling in 1980 that James Raper and his associates should make a mandatory bid for St. Piran plc. See, e.g., *Takeover Panel Rules on St. Piran*, THE TIMES, April 2, 1980, at 19. Raper, based in Hong Kong, was able to flout the Panel's ruling. See, e.g., Michael Prest, *The Strange Affair of St Piran*, THE TIMES, April 29, 1981, at 23.

<sup>274</sup> European Parliament and Council Directive 2004/25/EC on Takeover Bids, OJ L 142/12 (2004).

<sup>275</sup> The first proposal for a directive on takeovers was made by the European Commission as long ago as 1989. See EUROPEAN COMMISSION, REPORT OF THE HIGH-LEVEL GROUP OF COMPANY LAW EXPERTS ON ISSUES RELATED TO TAKE-OVER BIDS 13-17 (2002) (THE “WINTER REPORT”) (detailing history of negotiations).

<sup>276</sup> See Directive 2004/25/EC, *supra* note 274, Arts. 4 (supervisory authorities), 5 (mandatory bid), and 9 (obligations of the board of the offeree company).

<sup>277</sup> *Id.*, Art. 11. The breakthrough rule neutralizes (subject to the payment of “equitable compensation”) provisions in the target company's constitution and in contractual agreements between shareholders that provide for voting arrangements other than one-share, one-vote in the following circumstances: (i) after a bid has been announced, in decisions about the use of defensive tactics which the board is bound to refer to shareholders (*id.*, Art. 11.3); and (ii) after a bidder has acquired 75% of more of the capital carrying voting rights, as regards the appointment and removal of board members or amendment of the constitution (*id.*, Art 11.4). See generally Blanaid Clarke, *Articles 9 and 11 of the Takeover Directive (2004/25) and the Market for Corporate Control*, J. BUS. L. 355, 365-372 (2006).

rules proved so controversial that the Directive was only passed by making these rules optional.<sup>278</sup>

The Directive adopts a model of regulatory (rather than judicial) oversight through a “supervisory authority”. Whilst full-blown self-regulation was politically unacceptable in most Member States, the UK was able to negotiate for a text that permitted the Panel to be recognized as a supervisory authority through the expedient of domestic legislation empowering the Panel to act as such.<sup>279</sup> This has required the Code, for the first time in its history, to be put on a statutory footing.<sup>280</sup> However, this has been done with only minimal change to how the Panel is constituted and how it goes about writing and applying the Code.<sup>281</sup> In form, the Code is therefore now statutory, but the substance of its self-regulatory approach has been preserved. Indeed, it is anticipated by the UK government, the Panel, and many commentators, that little will change in the Panel’s practice as a result of the Directive.<sup>282</sup>

Alongside the Panel’s change in legal status have come new powers to request court enforcement of its rulings.<sup>283</sup> It might be thought that such juridification will bring with it the possibility of tactical litigation in UK takeover disputes. Foreign investors in particular, unschooled in the UK’s tradition of self-regulation, might be keen to raise a legal challenge if given the opportunity. However, at the UK’s insistence, Article 4(6) of the Directive provides that it does not affect any power of Member State courts “to decline to hear legal proceedings and to decide whether or not such proceedings affect the outcome

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<sup>278</sup> *Id.*, Art. 12. Member States implementing the Directive have the choice either to enact the board neutrality and breakthrough principles as mandatory rules *or* as opt-in defaults.

<sup>279</sup> *Id.*, Art 4.1 (“[A]uthorities ... shall be either public authorities, associations or private bodies recognised by national law...”).

<sup>280</sup> See The Takeovers Directive (Interim Implementation) Regulations 2006 (S.I. 2006/1183) (transitional provisions, in force from 20 May 2006); Companies Bill 2006 (formerly Company Law Reform Bill 2006), clauses 909-932 (provisions to be enacted in Spring 2007). Under these, the Panel’s Code Committee is empowered to write the Code, and its Hearing Committee to give binding rulings on its application.

<sup>281</sup> One change has been the inauguration of a new Takeover Appeal Board to hear appeals from decisions of the Panel.

<sup>282</sup> See Baker & Sagayam, *supra* note 63, at 386-389; DEPARTMENT OF TRADE AND INDUSTRY, COMPANY LAW IMPLEMENTATION OF THE EUROPEAN DIRECTIVE ON TAKEOVER BIDS: A CONSULTATIVE DOCUMENT 11-17 (2005); TAKEOVER PANEL, THE IMPLEMENTATION OF THE TAKEOVERS DIRECTIVE, PCP 2005/5, 2-3 (2005); Geoffrey Morse, *Implementing the Thirteenth EC Directive—The End of Self-Regulation in Form Only*, J. BUS. L. 403 (2005).

<sup>283</sup> S.I. 2006/1183, reg. 11; Companies Bill 2006, clause 922.

of a bid” and Member States’ power “to determine the legal position concerning the liability of supervisory authorities or concerning litigation between the parties to a bid.” The UK has relied on this provision in its implementation of the Directive. To counter the possibility that the Code’s new legal basis might engender civil suits based on breach of its provisions, the new UK legislation expressly provides that contravention of the Code shall not have any consequence for the validity of transactions, nor give rise to any civil action against the wrongdoer.<sup>284</sup> Moreover, the Panel are exempted any legal liability save for acts committed in bad faith, or which contravene the UK’s Human Rights Act 1998.<sup>285</sup> Thus the Panel’s current mode of regulating seems secure for the foreseeable future.

At the same time, other developments in European company law raise the possibility that a certain degree of regulatory competition may emerge within the EU.<sup>286</sup> The Takeover Directive prescribes that national takeover regulators will have jurisdiction to govern disputes relating to targets that are registered and listed in their jurisdiction, even if their main place of business is in another Member State.<sup>287</sup> When coupled with other recent European law developments that open the door for established companies to change their registered offices,<sup>288</sup> this raises the possibility that takeover regulation may in Europe, as it has been in the US for many years, become subject to regulatory competition.<sup>289</sup> If, as we have argued, the UK system of takeover regulation is generally desirable in the context of a corporate governance regime where stock

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<sup>284</sup> S.I. 2006/1181, reg. 12; Companies Bill 2006, clause 923.

<sup>285</sup> S.I. 2006/1181, reg. 16; Companies Bill 2006, clause 928. While the Panel’s decisions will still remain subject to the possibility of judicial review, the principle of no retrospective effect articulated in *Datafin* would appear to be protected by Article 4(6) of the Directive.

<sup>286</sup> See generally sources cited *supra* note 7.

<sup>287</sup> Directive 2004/25/EC, Art. 4.2(a). A company may opt into aspects of a Member State’s takeover regime concerning the conduct of a bid simply by listing in that jurisdiction (*id.*, Art. 4.2(b)). However, matters relating to the treatment of employees, the determination of “control” and the use of defensive tactics are left to the jurisdiction of the company’s registered office (*id.*, Art 4.2(e)).

<sup>288</sup> The most significant of these developments to date for established companies is the Cross-Border Mergers Directive: Parliament and Council Directive 2005/56/EC on Cross-Border Mergers of Limited Liability Companies, OJ L 310/1 (2005). A recent European Court of Justice ruling has established that the Member State in which a merged entity has its registered office must recognize the company as operating there, even if its principal place of business is elsewhere: Case C-411/03, *SEVIC Systems AG*, OJ C 36/5 (2006).

<sup>289</sup> See Gérard Hertig Joseph A. McCahery, *Company and Takeover Law Reforms in Europe: Misguided Harmonization Efforts or Regulatory Competition?*, in AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE US (JOHN ARMOUR & JOSEPH A. MCCAHERY, EDS., 2006), \_\_\_\_, at \_\_\_\_-\_\_\_\_.

ownership is dispersed, and the difference from the US' regime results from the federal pre-emption of self-regulation, rather than pathologies of regulatory competition, then European shareholders—and the UK's Panel—should have nothing to fear from this. Our prediction would be that continental European firms undergoing a transition from blockholder to dispersed share ownership—a re-listing, for example, following a private equity exit—would find the UK's takeover regime a relatively attractive one.<sup>290</sup>

### C. Will Growing Investor Activism Impact US Takeover Regulation?

If the influx of foreign investment, the Takeover Directive, and the possibility of regulatory competition are the major new developments on the UK horizon, the key variable in the US is the recent emergence of institutional shareholders as a major factor in US corporate governance. Two developments have taken center stage: namely, the sheer size of institutional shareholdings, and the even more recent corporate activism of hedge funds.

During the 1950s and 1960s, the era of the first hostile takeovers, institutional share ownership was puny by UK standards. As reflected in Figure 1, institutions held barely ten percent of US equity in 1960 and well under twenty percent in the early 1970s, whereas UK institutional shareholdings were roughly twice as high. As of 2004, however, the picture looks quite different. US institutions now hold fully half of all shares, having even eclipsed the ownership levels of their UK peers.<sup>291</sup> Might institutions begin to reshape American takeover regulation in their image?

In the early 1990s, when they first discovered institutional shareholders, some corporate law scholars were at least cautiously optimistic that these shareholders could revolutionize American corporate governance, ending the long tradition of shareholder passivity.<sup>292</sup> It quickly became apparent that conflicts of interest and free riding problems would prevent institutional shareholders from becoming nearly as great a force as their shareholding stakes might imply.<sup>293</sup> Yet pension funds, mutual funds and other institutional shareholders are now a much more important force in US corporate governance than in the past. The

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<sup>290</sup> See Armour, *supra* note 7, at 390-391.

<sup>291</sup> UK institutions now hold slightly less than fifty percent of UK shares. See Figure 2, *supra* text to note 188.

<sup>292</sup> See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Black, *supra* note 185; Bernard Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1 (1992).

<sup>293</sup> See, e.g., Rock, *supra* note 185; Fisch, *supra* note 270.



institutions themselves trace their greater involvement to early 1988, when the Department of Labor sent a letter to Avon suggesting that pension fund managers have an obligation to act as informed fiduciaries when they vote on corporate issues.<sup>294</sup> Within a few weeks, the client list of Institutional Shareholder Services (ISS), which shareholder activist Robert Monks had founded several months earlier to provide advisory services, mushroomed as institutional shareholders sought advice on voting and other issues. Two decades later, Institutional Shareholder Services has become a significant enough presence in US corporate governance that a critic recently complained that a new SEC rule requiring institutions to disclose their votes has “shift[ed] control over US public companies from their boards to [ISS].”<sup>295</sup>

Our analysis of UK institutions’ activism on rules issues, as contrasted with company-specific activism, suggests that it is at least possible that US institutional shareholders will press for takeover reform. Although US institutions are still more far-flung than their UK counterparts, ISS serves as a focal point for coordination, and institutions as a group would benefit from more shareholder-oriented takeover regulation. Recent ISS support for increased shareholder democracy in directorial elections could be seen as the precursor to more active involvement in takeover regulation.

Despite their new clout, however, we doubt that the institutions represented by ISS will make a serious dent in existing takeover regulation, much less privatize the process as their UK counterparts did in the 1960s. First, as we have seen, the option of privatization is entirely ruled out by the New Deal’s securities acts. We suspect that the traditional American suspicion of financial institution influence would quickly rear its head if institutional shareholders attempted to assert direct control over takeover regulation.

Secondly, the existing mode of regulation—judge-made law—imposes greater co-ordination costs on groups seeking to change the rules than would more centralized regulation. Because investor engagement is focused into lawsuits, which relate to particular sets of facts, US institutions seeking to co-ordinate must do so in the shadow of the immediate costs and benefits of litigation. Against this background, the collective benefits, to the institutions as a group, of changing the law through establishing a precedent will seem less salient. The

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<sup>294</sup> Avon Prods. Inc., Dep’t of Labor Letter Opinion, 15 Pens. Rep. (BNA) 391 (Feb. 23, 1988).

<sup>295</sup> Lynn A. Stout, *Why Should ISS Be the New Master of the Corporate Governance Universe?*, CORP GOV. (Dow Jones), Jan. 4, 2006, at 14, 14. ISS currently has a total of 1667 clients. See Institutional Shareholder Services, *About Us*, available at <http://www.issproxy.com/about/index.jsp>

evidence to date suggests that the costs of co-ordinating on litigation are considerable.<sup>296</sup>

Thirdly, whilst it would in theory be open for the institutions to lobby for SEC oversight of takeover defenses, Delaware's accommodation of its judicial process to the exigencies of the takeover era has reduced the gains to be expected from an alternative regulatory regime. Delaware also could be expected to fight any movement to dislodge its courts from their central role in takeover regulation. Moreover, although the other forty-nine states are also-rans in the competition to attract corporate charters, many would resist any movement that challenged the antitakeover laws they have put in place to discourage takeovers of companies incorporated in the state.

While the kinds of institutional shareholders that are represented by ISS are unlikely to do more than nibble at the edges of American corporate governance, a very different kind of institution, hedge funds, has taken a more aggressive stance. Hedge fund (and to a lesser extent equity fund) activism has been the most dramatic new development in American corporate governance. High profile skirmishes between hedge funds and the management of Time-Warner, General Motors and other corporations have served warning that hedge funds are not likely to sit idly by when they invest in publicly held companies. Will hedge funds re-shape the contours of US takeover regulation?

As with the more traditional institutions, we doubt that hedge funds will alter the course of US regulation, but for almost precisely the opposite reason. Rather than holding a broad portfolio of stocks, the hedge funds that have ventured into corporate governance make large, targeted investments in a small number of companies. This gives them a powerful incentive to engage in single company activism, but much less of an incentive to focus on improving the overall rules of the game.<sup>297</sup> As a result, even if the new hedge fund activism shakes up US

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<sup>296</sup> In a recent empirical study on securities fraud class actions, Cox and Thomas find that whilst the presence of an institutional investor as lead plaintiff is statistically associated with a higher settlement rate (*see* Randall S. Thomas and James D. Cox, An Empirical Analysis of Institutional Investors' Impact as Lead Plaintiffs in Securities Fraud Class Actions, Vanderbilt Law and Economics Research Paper No 06-09, March 2006), approximately only 30% of institutional investors with provable losses bother to perfect their claims in class action settlements: *see* James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STANF. L. REV. 411 (2005).

<sup>297</sup> This is especially true given that, unlike traditional institutional shareholders, hedge funds are not forced to keep most or all of their investments in the equity and debt markets. Hedge funds can invest in almost anything they wish, which means that they simply exit the equity markets as an alternative to attempting to improve the rules of the game.

corporate governance generally, it is unlikely to dramatically alter US takeover regulation.

We do not mean to suggest that institutional shareholders will have no effect on the US takeover markets at all. But the court-centered US approach seems likely to endure even as international financial markets are transformed by the rise of hedge funds and advent of sophisticated new forms of financial intermediation.

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The one issue on which hedge funds and equity funds do lobby actively is regulation of the funds themselves. For a discussion of equity funds' recent efforts "to pre-empt the types of moves toward federal regulation that have emerged for their hedge-fund cousins," see Brody Mullins & Kara Scannell, *Buyout Firms Join Lobbying Efforts*, WALL ST. J., Sept. 1, 2006, at A4.

## VI. CONCLUSION

In both the English and American systems of corporate governance, each of which feature dispersed share ownership, the hostile takeover is thought to operate as a disciplinary mechanism for management. Yet both the content of the rules governing the resolution of takeover battles, and the way in which they are made and enforced, are quite different in the two systems. Our analysis has explored the causes of this divergence, and its implications for policymakers.

Critics of the US system have compared it unfavorably to the UK's takeover regulation, and accounted for the difference as flowing from the dynamics of competitive federalism. Our public choice account, in contrast, places the mode of regulation at center-stage in explaining how the differences emerged. Public choice theory implies that legal rules will come to favor the interests of the group(s) with the greatest influence over the rule-making process. In a system of self-regulation, those groups which have the greatest interest in the regulated activity are likely to organize themselves so as to control the rule-making agenda. This fits squarely with the fact that British institutional investors, who for many years have owned the majority of the shares in UK quoted companies, are the group whose interests have shaped the Takeover Code.

Regardless of how well informed they are about policy issues, judges can only decide cases which come before them. Thus in a system where the law is judge-made, the crucial issue is which group is able to exert the greatest influence over the decision to take cases to trial. The structure of bidder and shareholder litigation to enforce directors' duties—for example, in a hostile takeover bid situation—tends to be biased towards the interests of directors, leading the content of precedents to tend to be more favorable to their interests. Our claim that the difference in substance flows from the mode of regulation, as opposed to the existence of regulatory competition in the US, is reinforced by the fact that the *common law* of directors' duties in the UK, which is not a federal system, is much closer to the substance of the US model than it is to the Takeover Code.

The question posed by this analysis is why the UK institutional investors were able to “privatize” their takeover regime through self-regulation, whereas their counterparts in the US were not. The answer to this, we consider, lies in the decades old legislation that fragmented US financial institutions and vested authority over the markets in the SEC. Congress not only made it more difficult for institutional investors to co-ordinate, but it directly preempted certain types of self-regulation by stock exchanges. Had it not been for these legal features of the US landscape, we think it likely that institutional investors would have been able to coordinate similarly to their UK counterparts so as to obviate the need for litigation. Given that both the process and substance of the UK's self-

regulatory regime are selected and developed by those who have most at stake in the process, there are strong *prima facie* reasons for thinking it may be superior to that which has prevailed in the US.

The implications of this for US policymakers are twofold. On the one hand, the costs of the federal legislation which restricted institutional investor interaction may be significantly more than have been appreciated. At the same time, there is a certain irony in the fact that prominent critics of US takeover law suggest that the solution is to introduce federal legislation along the lines of the UK's Takeover Code. Federal regulation is the explanation for the managerialist US approach, not the solution, in our view.

Our rejection of the “orthodox” explanation for the more manager-friendly US takeover rules, which is based on alleged pathologies of regulatory competition, also has important implications for the growing possibilities for regulatory competition within the EU. Our account, in contrast, does not imply that the UK's takeover regime is likely to be weakened by developing regulatory competition. If anything, we expect its cost advantages to attract, rather than deter, reincorporations.

Finally, the contrast between the US and UK approaches has considerable relevance for emerging economies both in Europe and elsewhere in the world. Reformers have too often assumed that the top-down, mandatory regulation, together with courts, is the only way to regulate corporate transactions in emerging economies. But the success of the UK's Takeover Panel suggests that this assumption is seriously flawed. The US approach requires an effective governmental regulator, together with an efficient court system. In many emerging economies, one or both of these elements is missing. In some, the parties that are most directly affected by corporate regulation— large shareholders, banks and exchanges— are located in close proximity to one another. And they have a direct financial stake in the success of the regulatory framework. In this context, informal self-regulation might prove more effective than the US combination of formal statutes and courts. The UK strategy will not invariably be the best, any more than the approach in the US. But reformers and lawmakers should keep in mind that there at least two ways to regulate takeovers, not just one.