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The Stock Market, the Market for Corporate Control and the Theory of the Firm: Legal and Economic Perspectives and Implications for Public Policy

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The Stock Market, the Market for Corporate Control and the Theory of the Firm: Legal and Economic Perspectives and Implications for Public Policy

Simon Deakin and Ajit Singh[i]

Abstract

It is argued here that – contrary to current conventional wisdom – an active market for corporate control is not an essential ingredient of either company law reform or financial and economic development. The absence of such a market in coordinated market systems during their modern economic development was not an evolutionary deficit, but an effective and positive institutional arrangement. The economic and social costs associated with restructuring driven by hostile takeover bids, which are increasingly seen as prohibitive in the liberal market economies, would most likely harm the prospects for growth in developing and transition systems.

1. Introduction

In this paper we consider the relationship between shareholder value, the market for corporate control, and economic and legal theories of the firm. We argue that, contrary to current conventional wisdom, support for an active market for corporate control is neither a core principle of company law, nor an essential ingredient of financial and economic development.

Indeed, the opposite could well be the case – an important element of reform should be the prevention of the emergence of a market for corporate control. The absence of such a market in coordinated market systems, such as Germany and Japan during their modern economic development, was not an evolutionary deficit, but an effective and positive institutional arrangement. The unraveling of that arrangement, which is currently being encouraged by regulatory changes and which some commentators see as a necessary part of adjustment to globalization, has the potential to destabilize existing production regimes, although so far it has failed to have this effect. Aspects of a regulatory regime favourable to the market for corporate control, such as a mandatory bid rule, have been adopted in many developing economies over the past decade; however, in the absence of countervailing power for employees of the kind found in most European systems, it is possible that these developments could impose significant economic and social costs associated with restructuring.

Our paper is ordered as follows. Section 2 outlines the relationship between shareholder value and the core principles of company law in the common law and civil law worlds. It is argued here that company law systems, regardless of legal origin, tend to recognize the principle of managerial autonomy from shareholder control, and provide managers with discretion to run the company in such a way as to maximize returns to all stakeholders and not simply shareholders. Section 3 turns the focus to takeover regulation, which we suggest is the pivotal factor that has led to the prioritization of shareholder interests in common law systems. We explore the different approach to takeover bids in civilian regimes and discuss the implications of attempts to encourage a market for corporate control through regulatory changes in continental Europe and Japan before looking at the adoption of similar regulatory moves in emerging and transition systems.

Having reviewed the common law and civil law approaches to the market for corporate control, Section 4 turns to economic analysis. The takeover mechanism plays a pivotal role in many branches of economic theory including the theory of the firm, the theory of industrial organization and welfare economics. It is also critical to an analysis of economic and industrial policy. We, however, confine ourselves in this paper to analyzing the relationship between the market for corporate control and the theory of the firm. This subject is examined in Section 4, together with a discussion of alternative views on the efficiency of takeovers, and the need or otherwise of government regulation. Section 5 contains a discussion of the pricing process and the takeover mechanism on the stock market. It provides empirical evidence on aspects of the market for corporate control. Section 6 briefly concludes.

2. Shareholder value and the legal conception of the firm in the common law and civil law

The idea that the managers of private-sector companies should act as the agents of shareholders is a focal point of the contemporary corporate governance debate. According to this view, the pursuit of shareholder value is the single 'corporate objective function' which drives organizational and allocative efficiencies (Jensen, 2001). Its influence is increasingly felt in civilian systems that have, up to now, enjoyed a different tradition, and its adoption in transition economies and in the developing world is on the policy agenda there. This apparent convergence is occurring in large part as a result of 'the recent dominance of a shareholder-centred ideology of corporate law among the business, government and legal elites in key commercial jurisdictions' (Hansmann and Kraakman, 2001: 439).

Too close a focus on the supposed efficiency of prevailing institutions is liable to make us forget the often tortuous and uneven path by which they came to acquire their apparent dominance. Britain's industrial revolution took place during a period when few businesses enjoyed limited liability. In the US, many states allowed personal claims to be brought against shareholders for corporate debts late into the nineteenth century and some, including California, into the twentieth. Yet corporate law scholars today assert that limited liability and the partitioning of corporate from personal assets are essential parts of the legal 'bedrock' supporting enterprise (Hansmann and Kraakman, 2000). This view arguably ascribes 'survival value' to institutions whose endurance may have more to do with historical contingency than efficiency (Deakin, 2003). Is the same true of today's norm of shareholder value?

It is surprisingly difficult to find support within core company law for the notion of shareholder primacy. It cannot be found by referring to the rhetorical claim, associated with today's pension funds and other institutional investors, that shareholders 'own the company'. No legal system acknowledges the claims that shareholders 'own the company'. If we understand the company to be the fictive legal entity which is brought into being through the act of incorporation, it is not clear in what sense such a thing could be 'owned' by anyone. But more pertinently, nor does the ownership of a share entitle its holder to a particular segment or portion of the company's assets, at least while it is a going concern (see Parkinson, 2003).

The law on directors' duties is no more helpful. In the English-law based common law systems, with only a few exceptions, directors' fiduciary interests of loyalty and care are owed to the *company*, not directly to the shareholders. In practice, the company's 'interests' will often be synonymous with those of its members, that is, the shareholders. However, shareholders are not entitled to engage directly in the management of the enterprise; this is the responsibility of the board. According to Delaware corporate law, ‘the business and affairs of every corporation… shall be managed by or under the direction of a board of directors’ (see Millon, 2002: 92). Many of the formative cases of English company law, dating from the nineteenth and early twentieth centuries, make the same point (see Davies, 1997: 183-88).

Company law does not say anything of the level of returns to which shareholders are entitled; nor of the time scale over which their expectations are to be met. This ambiguity enabled the Company Law Review Steering Committee, in the review of UK company law which was concluded in 2002, to express its support for the idea of ‘enlightened shareholder value’: this implies ‘[a]n obligation on directors to achieve the success of the company for the benefit of the shareholders by taking proper account of all the relevant considerations for that purpose’ including ‘a proper balanced view of the short and long term, the need to sustain effective ongoing relationships with employees, customers, suppliers and others; and the need to maintain the company’s reputation and to consider the impact of its operations on the community and the environment’ (Company Law Review Steering Group, 2000: 12; see also Company Law Review Steering Group, 2001: 41).

The Steering Group regarded its proposal was as compromise between the ‘enlightened shareholder value’ position and a ‘pluralist’ point of view which would have seen management as having multiple commitments to a range of stakeholder groups. The Steering Group accepted the position of agency theory, that making management formally accountable to a diverse body of stakeholders might limit the effectiveness of managerial decision-making and blur lines of accountability. Nevertheless, the Steering Group's proposal was based on the proposition that 'companies should be run in such a way which maximizes overall competitiveness and wealth and welfare *for all*' (emphasis added). The means chosen to achieve this end were the 'inclusive duty' and 'broader accountability':

> The proposed statement of directors' duties requires directors to act in the collective best interests of shareholders, but recognises that this can only be achieved by taking due account of wider interests. The transparency element provides the information needed to underpin this approach to governance. Just as importantly, we believe that [a] wider reporting requirement – particularly for large companies – will be an important contribution to competitiveness. Companies are increasingly reliant on qualitative and intangible, or 'soft' assets such as the skills and knowledge of their employees and their corporate reputation. The reporting framework must recognize this and ensure that companies provide the market and other interests with the information they need to understand their companies' business and assess performance. (Company Law Review Steering Group, 2000: 14-15).

Section 172 of the Companies Act 2006, which is headed 'Duty to promote the interests of the company', now provides that:

> (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole…

(3) In fulfilling the duty imposed by this section a director must (so far as reasonably practicable) have regard to –

(a) the likely consequences of any decision in the long term,

(b) the interests of the company's employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment

(e) the desirability of the company maintaining a reputation for high standards of business conduct ,and

(f) the need to act fairly as between the members of the company.

Such a position is by no means as contrary to US corporate law as many writings on that system might make it seem. According to Leo Strine, a leading Delaware company law judge, writing extra-judicially, but expressing a view which is arguably quite compatible with the general thrust of Delaware *law* (as opposed to corporate governance *practice*) on the issue of shareholder value:

Most American workers obtain the bulk of their wealth from their labour and even most top American managers can trace their wealth (including the equity they have accumulated) to their labour as executives. Therefore, both management and labour might be thought to have more concern than trust fund babies or investment bankers do for the continued ability of American corporations to support domestic employment. Likewise both management and labour are likely to view a public corporation as

> something more than a nexus of contracts, as more akin to a social institution that, albeit having the ultimate goal of producing profits for stockholders, also durably serves and exemplifies other societal values. In particular, both management and labour recoil at the notion that a corporation's worth can be summed up entirely by the current price equity markets place on its stock, much less that the immediate demands of the stock market should thwart the long-term pursuit of corporate growth. (Strine, 2007: 4)

The idea that the company is an organisation or 'entity' with a distinct set of interests above and beyond those of all the stakeholder groups combined is even more clearly articulated in the civil law systems. These recognize the 'enterprise' as a legal form that corresponds to the organization. This is distinct from the concept of the 'company' that essentially describes a set of claims to income streams and property rights. The explicit recognition of the company's organizational dimension has implications for the way in which stakeholder interests are recognized, as this quotation from the Viénot report on French corporate governance recognized:

> In Anglo-Saxon countries the emphasis is for the most part on placed on the objective of maximising share values, whilst on the European continent and France in particular the emphasis is placed more on the human assets and resources of the company… Human resources can be defined as the overriding interest of the corporate body itself, in other words the company considered as an autonomous economic agent, pursuing its own aims as distinct from those of its shareholders, its employees, it creditors including the tax authorities, and of its suppliers and customers; rather, it corresponds to their general,

common interest, which is that of ensuring the survival and prosperity of the company (Viénot, 1995, cited in Alcouffe and Alcouffe, 1997).

Various versions of this concept of the ‘company interest’ have been expressed in continental European law and practice since the period of industrialisation in the second half of the nineteenth century; it was articulated in the ‘communitarian’ concept of the enterprise advanced by the German jurist Otto von Gierke in the 1890s, and in the corporatist model popularised by the industrialist and politician Walther Rathenau in the 1920s. Although German corporate law scholarship has been increasingly influenced by agency theory since the 1990s, a significant strand of it remains sceptical of the US-inspired model, and theories based on the varieties of capitalism approach, stressing the importance of firm-specific human capital in coordinated market systems, have recently been deployed to explain and defend the core civilian model (see Gelter, 2007 on Germany, and Rebérioux, 2007 on France).

3. The legal regulation of takeover bids: common law and civilian approaches[ii]

3.1 The origins of takeover regulation

The vital factor in institutionalizing the shareholder value norm in the common law or ‘liberal market’ systems has been the encouragement given to the hostile takeover bid by regulatory changes which have often been in tension with the core principles of company law. Takeover regulation is a comparatively recent phenomenon. Following the economic depression of the inter-war years, there was intense discussion of the responsibilities of companies, the role of the financial system, and the need for public regulation of the economy. The solution argued for by Adolf Berle, in particular in his debate with E. Merrick Dodd in the mid-1930s, was to reverse the 'separation of ownership and control' (which at that point was a comparatively new development in the US: see Hannah, 2006) by returning control to the shareholders (see Dodd, 1932; Berle, 1932). But this route was thought to be impractical during a period when it was generally considered that the large enterprise was the norm, family ownership was in decline, and further dispersion of ownership could be expected. Rather, the outcome was a combination of managerial and public control of the corporation, much as Dodd had advocated, and as Berle came belatedly to accept (Berle, 1962; see Ireland, 1999).

From the mid-1970s onwards, the intellectual climate in Britain and North America began to turn away from public and social control of industry, with results which are now familiar: the privatization of the large, state-owned corporations and utilities, and the so-called deregulation of many areas of economic life. As part of this policy turn, and as a result of the changes to industry and the economy that flowed from it, the corporate governance debate was relaunched. Corporate finance scholars argued that in place of the state, the market should provide the principal mechanism for controlling the managers of large corporations. These authors, in common with Berle and Means, argued that dispersed share ownership – the fracturing of share capital among hundreds, sometimes thousands of individual holdings – freed management from direct supervision by investors. The solution, however, lay in the activation of the very instrument which the legislation of the New Deal era in the United States, and of the post-war regulatory state in many other countries, had sought to constrain in the interests of economic stability: the capital market.

The mechanism by which this was achieved was the hostile takeover bid. By offering to buy shares in a company at a premium over the existing stock market price, so-called corporate raiders or predators could obtain control of the enterprise, remove the existing managerial team, and install one of their own. If the shareholders had no greater interest in the company than the financial investment represented by their shares, they could be induced to sell in return for the premium offered by the raider, in particular if they felt that the incumbent managerial team was not looking after their interests. For the bidder, the cost of mounting the bid and buying out the shareholders could be recouped, after the event, by disposing of the company's assets to third parties. If the company had not been well run before, these assets would, by definition, be worth more in the hands of others. Thus the hostile takeover bid performed a number of tasks. It empowered shareholders, who now had a means to call management to account if it was underperforming. Conversely, the hostile takeover disciplined managerial teams, who knew that their jobs and reputations were on the line if a bid was mounted. In addition, it provided a market-led mechanism for the movement of corporate assets from declining sectors of the economy to more innovative, growing ones. That, at least, was the theory.

The rise of the hostile takeover can be traced back to the late 1950s and early 1960s in the UK and US. There had always been mergers and acquisitions of firms; what was relatively new was the idea of a bid for control directed to the shareholders, over the heads of the target board. In the inter-war period, incumbent boards would 'just say no' to unwelcome approaches from outsiders, often without even informing shareholders that a bid was on the table (Hannah, 1974; Njoya, 2007). At this stage, accounting rules had not evolved to the point where companies were under a clearly enforceable obligation to publish objectively verifiable financial information. This changed in the post-war period as a consequence of the legal and accounting changes that were put into place in both Britain and America by way of response to the financial crises of the 1930s. Greater transparency made it easier for unsolicited bids to be mounted and more difficult for incumbent boards to resist them. Institutional protection for minority shareholders followed, with the adoption in Britain in 1959 of the Bank of England's Notes on Reconstructions and Amalgamations and, in 1968, the City Code on Takeovers and Mergers. 1968 was also the year in which the US Congress adopted the Williams Act, instituting a system of regulation for hostile tender offers for US listed companies.

3.2 The US model

The Williams Act sets time limits on tender offers and requires bidders with 5% of a company's stock to disclose their holdings and to give an indication of their business plan for the company, but it does not explicitly rule out two-tier or partial bids as it does not contain a mandatory bid rule along the lines of the City Code. It regulates fraudulent activity, broadly defined, but does not place target directors under a clear-cut duty of care to provide independent financial information to shareholders in the way that the Code does. At state level, US courts have accepted that, under the 'business judgment' rule, target directors can take steps to resist a hostile takeover where they act in good faith and with 'reasonable grounds for believing that a danger to corporate policy and effectiveness existed'; specifically, they can take into account the 'inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of non-consummation, and the quality of the securities being offered in exchange'.[iii] The Delaware courts have nevertheless vacillated between an ‘auction rule’ which would require the board to take steps to maximise shareholder returns in the event of a proposed change of control,[iv] and the ‘just-say-no’ defence under which the target board would be ‘obliged to charter a course for the corporation which is in its best interests without regard to a fixed investment horizon’ without being ‘under any per se duty to maximise shareholder value in the short term, even in the context of a takeover’.[v]

US corporate law has permitted the growth of a battery of anti-takeover defences of the type that are virtually never adopted in the case of publicly-quoted companies in Britain. *Shark repellents* structure the composition of the board may be structured so as to make it difficult for an outsider to gain control. For example, company byelaws may stipulate that directors are elected for 3-year terms, with only part of the board coming up for renewal each year. It is also common for byelaws to prohibit greenmail (a raider forcing the target board to buy back its shares at a premium), to prevent shareholders from voting by proxy, to lengthen the gaps between general meetings, and to require supermajority decisions to change these and other rules. *Poison pills* include various devices whereby insider shareholders acquire rights which are triggered when a hostile takeover bidder makes its entry have been permitted, including the *flip-in* (where if the raider increases its shareholding above a certain level the target board declares a high dividend for existing shareholders, or existing shareholders are given the right to buy additional stock at half the market price) and the *flip-over* (shareholders get the right to buy stock of the new parent at a 50 per cent. discount).

In addition, most states have enacted anti-takeover statutes that enable companies to adopt internal rules aimed at fending off hostile bids. The first wave of such statutes was ruled unconstitutional in *Edgar* v. *MITE Corp.*[vi] on the grounds that the Williams Act preempted them.

In this case, an Illinois statute that extended the bid timetable beyond that set by the Williams Act and gave state-level competition authorities the right to nullify offers was struck down. However, a second generation of 'share control' statutes (providing the incumbent shareholders with the power to decide on whether a raider with a controlling stake should retain the voting rights of its shares) was upheld in *CTS Corp.* v. *Dynamics Corp.*[vii] at around the same time as the Supreme Court gave a restrictive ruling to the Williams Act, deciding that it did not bar defensive actions such as 'crown jewel' options or sales.[viii] This simultaneously limited the scope of federal regulation and opened the way for further pro-defensive laws at state level. A 'third generation' of state laws followed, which, broadly speaking, validated various poison pill defences and introduced 'constituency' or stakeholder provisions into the definition of directors' fiduciary duties.

These 'stakeholder statutes' vary in strength. Certain of them include provisions for *profit disgorgement*, whereby the state imposes a high tax on any short-term profits by raiders acquiring shares in connection with a bid, for example as a result of *greenmail* (selling their shares back to the company at a premium to the market). Modifications to directors' duties include provisions to the effect that fiduciary duties are owed solely to the corporation and that no party, not even the shareholders, can enforce them directly; that directors may consider the long-term interests of the corporation; and that the directors need not regard any one constituency's interest as dominant. The stakeholder statutes, together with the adoption of poison pills by a majority of large public corporations, are credited with having helped to restrict the number and volume of takeovers at the end of the 1980s to an end: by the mid-1990s, over two-thirds of large US public corporations had adopted poison pills, and acquisitions of public corporations, which had been running at over 400 per annum in the late 1980s, had fallen to half that figure (Useem, 1996: 27-8). However, the stakeholder statutes did little to deflect the wider impact of shareholder pressure on corporate management, which today increasingly takes the form of pressure from activist hedge funds and private-equity led restructurings, and which has been reflected in continuing high levels of lay-offs and restructurings (Uchitelle, 2007).

3.3 The British model

The City Code, like the Williams Act, dates from the late 1960s, but unlike the US measure, it did not until recently have statutory backing. The Panel on Mergers and Takeovers, a self-regulatory body set up by the financial and legal professions and financial sector trade associations based in the City of London, had no direct legal powers of enforcement. Its provisions were strictly observed, however, since UK-based financial and legal professionals who were found to have breached the Panel's rulings could be barred from practicing as a consequence. As a result of the adoption by the European Union of the Thirteenth Company Law Directive,[ix] the Panel has recently acquired a statutory underpinning,[x] but the substance of the Code remains essentially the same as it was before, and it continues to be based on the Panel's deliberations and rulings. The expectation of both the UK government and of the Panel is that the implementation of the Directive will not have a major impact on the Panel's mode of operation.[xi]

The City Code reflects the strong influence of institutional shareholder interests within the UK financial sector, and their capacity for lobbying to maintain a regulatory regime, which operates in their favour (Deakin and Slinger, 1997; Deakin, Hobbs, Nash and Slinger, 2003). Its most fundamental principle is the rule of equal treatment for shareholders: 'all holders of the securities of an offeree company of the same class must be offered equivalent treatment'.[xii] This is most clearly manifested in the Code's 'mandatory bid' rule which requires the bidder, once it has acquired 30 per cent or more of the voting rights of the company, to make a 'mandatory offer' granting all shareholders the chance to sell for the highest price it has paid for shares of the relevant kind within the offer period and the preceding twelve month period.[xiii] Partial bids, involving an offer aimed at achieving control through purchasing less than the total share capital of the company, require the Panel's consent, which is only given in exceptional circumstances.[xiv] During the bid, information given out by either the bidder or target directors must be made 'equally available to all offeree company shareholders as nearly as possible at the same time and in the same manner'.[xv]

The Code also imposes on target directors a series of specific obligations that can be thought of as clarifying their duty to act *bona fide* in the interests of the company, but in some respects extend this duty. The target directors must first of all obtain competent, independent financial advice on the merits of the offer,[xvi] which they must then circulate to the shareholders with their own recommendation.[xvii] Any document issued by the board of either the bidder or the target must be accompanied by a statement that the directors accept responsibility for the information contained in it.[xviii] While the point is not completely clear, the likely effect of this is to create a legal duty of care, owed by the directors to the individual *shareholders* to whom the information is issued (and not to the *company* as is the case with their general fiduciary duties).[xix]

All this places the directors of the target in the position of being required to give disinterested advice to the shareholders on the merits of the offer, and makes it more difficult for them to resist a bid simply on the grounds that it would lead to the break-up of the company. In a case where the board considers that a hostile bid would be contrary to a long-term strategy of building up the company's business in a particular way, it can express this opinion, but it must be cautious in doing so, since it still has a duty to provide am objective financial assessment of the bid to the shareholders. In the case of the takeover of Manchester United FC by the US businessman Malcolm Glazer in 2005, the board took the view that Glazer's offer, because it would impose a high debt burden on the company, was not in its long-term interests. However, the board was also aware that the offer could well be regarded as a fair one, since it was by no means clear that the shareholders would not be better off by accepting it. The board issued this statement:

> The Board believes that the nature and return requirements of [the proposed] capital structure will put pressure on the business of Manchester United… The proposed offer is at a level which, if made, the Board is likely to regard as fair… If the current proposal were to develop into an offer… the Board considers that it is unlikely to be able to recommend the offer as being in the best interests of Manchester United, notwithstanding the fairness of the price.

Following this statement, a majority of the shareholders accepted Glazer's bid.

General Principle 9 of the Code used to state that 'it is the shareholders' interests, taken as a whole, together with those of employees and creditors, which should be considered when the directors are giving advice to shareholders'. This provision, like section 309 of the Companies Act 1985, was less significant in practice than in appeared to be on paper, since it provided no basis on which employees or creditors, who had (and have) no standing before the Takeover Panel, can challenge a board's decision. Case law on fiduciary duties from the 1980s also suggested that, during a *contested* takeover, *only* the interests of the shareholders could be taken into account.[xx] As a result it probably matters little that following recent revisions to the Code, the relevant General Principle, which is based on the parallel provisions of the European Union's Thirteenth Company Law Directive, now simply states that 'the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid'.[xxi]

The Code used to require the bidder to state, in its offer document, 'its intentions regarding the continuation of the business of the offeree company; its intentions regarding any major changes to be introduced in the business, including any redeployment of the fixed assets of the offeree company; the long-term commercial justification for the proposed offer; and its intentions with regard to the continued employment of the employees of the offeree company and its subsidiaries'. This meant little in practice; it simply required the bidder to issue a general statement of its intentions, which generally took the form of a standard-term or 'boilerplate' provision in offer documents. However, as a result of changes made to the Code following the implementation of the Thirteenth Directive, more prescriptive provisions concerning the potential impact of takeovers on employees have been introduced. The bidder must now provide detailed information on its strategic intentions with regard to the target, possible job losses, and changes to terms and conditions of employment,[xxii] and the target must give its views, in the defence document, on the implications of the bid for employment.[xxiii] Breach of these provisions is a criminal offence. They also have potentially significant implications for employees' consultation rights under labour law.[xxiv] In addition, employee representatives of the target have the right to have their views of the effects of the bid on employment included in relevant defence document issued by the target.[xxv]

The Code contains extensive provisions controlling the use of defences against hostile bids (or 'frustrating measures' in the terms used by the Thirteenth Directive). Once an offer is made or even if the target board has reason to believe that it is about to be made, the target board cannot issue new shares; issue or grant options in respect of any unissued shares; create securities carrying rights of conversion into shares; sell, dispose or acquire assets of a material amount, or contract to do so; or 'enter into contracts otherwise than in the ordinary course of business'.[xxvi] General company law is also relevant here. The 'proper purposes' doctrine prevents the board issuing shares for the purpose of forestalling a hostile takeover, even well in advance of any bid being made.[xxvii] Other advance anti-takeover defences, such as the issue of non-voting stock or the issuing of new stock to friendly insiders, have been discouraged by a combination of the Listing Rules of the London Stock Exchange and institutional shareholder pressure. Protection of pre-emption rights, or the rights of existing shareholders to be granted preference when new stock is issued, is recognised by legislation[xxviii] as well as by guidelines issued by stock exchange and financial industry bodies.[xxix] The issue of non-voting stock is permissible under general company law, but is vigorously opposed in practice by institutional shareholders.[xxx]

Thus the Takeover Code, taken in conjunction with related aspects of company law, can be seen to provide strong protection for the interests of the target shareholders; that, after all, has been its main purpose (see Johnston, 1980). An important side effect of this protection, however, is to encourage hostile takeover bids by placing limits on the defensive options available to the target management. An incumbent management is not required to be completely passive, and is permitted to put a case in its own defence, but opportunities for defence only arise in the context of an overriding responsibility to see that the shareholders' interests are safeguarded. The effect is not far removed from that of an 'auction rule' which requires the incumbent management to extract the highest possible price for the target shareholders, if necessary by making it possible for rival offers to be made. The entry of second bidders is facilitated by the bid timetable imposed by the Code and by the effective ban on two-tier and partial bids which might otherwise be used to strong-arm the target shareholders into accepting the terms of the first bid.

These regulatory features might be thought to deter bids, by increasing the risk that either the target shareholders or any second bidder will free ride on the efforts of the initial bidder. However, the possibility of free riding by the shareholders is alleviated by the right of the bidder compulsorily to purchase the last 10% of shares in the event of taking control; in the language of the European Directive, a 'squeeze-out' rule (on its economic effects, see Yarrow, 1985). Other factors which serve to reduce the risk of an initial bid failing due to free-rider effects are the concentration of voting shares in most UK publicly-quoted companies in the hands of a relatively small number of institutional shareholders (so reducing the number of shareholders who need to be persuaded to sell) and the right of an initial bidder to raise its offer price during the bid period (thereby enabling it to over-bid a second bidder). While there may, then, be a certain screening-out of partial bids which, given their oppressive nature, are arguably not efficiency-enhancing in any event (see Yarrow, 1985), the effect of the Code is to reduce the autonomy enjoyed by the management of the target company in relation to its shareholders and thereby to limit the defensive options it has available to it.

This suggestion is borne out by empirical research carried out in Cambridge in the late 1990s (Deakin, Hobbs, Nash and Slinger, 2002). In this study, the objective was to construct a sample of bids, which contained examples of both hostile and agreed bids, and cross-border bids by UK companies and for UK companies mounted during the period 1993-1996. In interviews we put this question to company directors, lawyers, merchant bankers, institutional shareholders and employee representatives:

> Did directors' duties to consider interests of creditors and employees as well as those of shareholders affect the preparations for, the conduct of and the aftermath of the bid?

On the central question of directors' duties, the response was almost invariably that while directors might consider employees' and creditors' interests, the outcome of a bid was determined by shareholder value. Shareholder value took precedence over all other considerations. The responses to the question are separated out below by group, with advisers first, followed by directors, employee representatives, and institutional investors.

A typical comment from an adviser was as follows:

> Directors *do* consider employees' interests, but no-one really knows what that means. At the margin the touchy-feely things matter, but the board of directors, faced with 2 people offering £1 and £1.10 must go for the higher. The decision, of course, is not usually put like that, but I don't know of any cases where employees' interests have come first.

Employees were only mentioned out of lip service to the obligation of the offeror company to state its intentions with regard to employment:

> Directors' duties to consider other interests are rarely an issue unless the company is near to insolvency. These clauses together are a bit of a sop. Rule 24 of the Code

> requires a statement of intentions towards employees, which always gets reduced to the standard phrase: 'the bidder will ensure that all rights of the target employees will be met in full.' Sometimes people do say more - sometimes a target will screw a stronger statement out of the bidder. And where companies intend not to make redundancies, they will tend to say it.

More pithily, we were told: 'much is spoken about directors' duties to employees, but it is rarely relevant'; and, 'the Takeover Code and Companies Acts just muddle these issues up: directors have to recommend 'the deal' when they are really just recommending the price.'

Directors told us that their focus was on the financial aspects of a bid:

> The one thing that [our merchant bankers] kept saying was that 'you have to be sure that when you say that a price is inadequate, you mean it and can back it up.' Were we advised that we could take into account the interests of the company as a whole? No - the primary advice was that 'there is a price at which you have to say yes.'

In particular, non-executive directors were identified as advocates for the shareholder interest, even where this meant dismembering the corporate enterprise:

> Were we advised of our legal obligations to our shareholders? Yes - there was lots of advice. One of the non-executive directors did push us hard to consider closure and selling up as an option to get maximum shareholder value (about 5 years before the bid).

Institutional investors likewise thought that directors should focus on shareholder concerns. One was ‘happy with the idea that directors owe duties to ‘the company’ but was of the view that ‘during a bid, especially, the directors understand this as being a duty to shareholders.’ Another considered that for directors to perform according to their fiduciary duties, ‘they had to show that it was in the interests of shareholders to sell’. The pursuit of stakeholder interests was not seen as a viable alternative to shareholder value:

> It is hard to make a case that [the duty further the interests of the company as a whole] affected the bid greatly. In principle a defending company might put employees’ interests before those of shareholders but they are basically serving shareholders’ interests first. If directors have a duty, it is to ensure that employees have marketable skills. I see directors’ duties to employees as being more like pension rights protection than long-term employment safeguards.

Employee representatives were less clearly opposed to bids than might have been thought. Hostile bids were sometimes seen as shaking up incumbent managerial teams with which the employees had little by way of common interest. Hence employee representatives commented unfavourably on the tendency of target directors to be excessively well rewarded, even before bids, in pay and share options, and on the negative effect that this had on the workforce. Particular criticism was reserved for the practice of linking managerial remuneration to the number of workers dismissed:

> The other thing that caused trouble was the directors' incentives schemes. They had a bonus system which had work completed according to certain targets divided by the number of staff that they employed to do it. So what they did was to sack a lot of staff, and employed outside contractors, to fulfill their conditions and increase their bonuses.

None of the employee representatives were convinced that a higher commitment from management to consultation would have materially affected the bids in which they were involved. In part this was out of a frank recognition that the decision was in the hands of shareholders and hence was 'purely a commercial thing'. The priority was to keep lines of communication open after the bid in an attempt to avoid compulsory redundancies and smooth the way of the new owners. This was a typical comment:

> We take the view now that we're not going to be able to prevent [the takeover] - so we try to get the best deal we can. Given the current industrial relations climate, I don't think that even a 'requirement to consult' would make much difference.

For target directors, the nature of the advice received was of paramount importance. During bids, they saw their duty in terms of maximizing the potential value of the company *as a financial asset of the shareholders*. This obligation stood before any requirement to consult employees, to consider their interests, or to further the interests of the company as a whole. Even outside the bid period, the perceived 'duty' to focus on shareholder value could lead a non-executive director to see it as his role to force management to consider closing down the enterprise. Correspondingly, institutional investors applauded directors who saw their responsibilities in these terms.

The attitudes of employee representatives are best described as pragmatic. They expected little from target managers whose interests were seen to be tied up with share options and remuneration packages that would leave them better off whatever the outcome of the bid. There was no expectation of consultation with the target management, and no prospect of it making a difference to the outcome of the bid if it did take place. By contrast, the intervention of bidders could be seen in a positive light, particularly where there had already been a breakdown of trust with incumbent management. Informal links could be established with the bidder at an early stage, and a relationship constructed with a view to the future, even it was recognised on both sides that the most immediate issue was likely to be the management of redundancies.

In 1974 Leslie Hannah wrote that the takeover bid had ushered in ‘an economic system whose logic is still being developed and is still only imperfectly understood’ (Hannah, 1974). We now see more clearly what kind of system it is. The takeover revolution was a catalyst for a raft of other measures and devices aimed at ensuring that managers of large corporations acted first and foremost in the interests of their shareholders. However, it is important to stress that even in the UK context, the current focus on shareholder value is therefore the consequence not of the basic company law model, but of those institutional changes which have occurred in capital markets and securities law with increasing rapidity in particular since the early 1980s, namely the rise of the hostile takeover bid, and the increasing use of share options and shareholder value metrics. Thus the contemporary ‘norm’ or reference point of shareholder primacy is the result of a mix of institutional changes, the emergence of new forms of self-regulation and soft law, and shifts in corporate culture.

3.4. The civil law model: mainland Europe

In the civil law world, there has, until recently, been no equivalent to the rules on takeover regulation that are found in common law systems. This is not to say that there is no record, historically, of hostile takeover activity in civil law countries; as Hannah (2007) points out, takeovers by share purchase did take place in Germany in the early years of the twentieth century. However, for much of the twentieth century, there were actively suppressed, particularly post-World War II period when they were seen as incompatible with economic reconstruction in Germany, France and Japan. The growth of corporate cross-shareholdings and the rise of bank-led governance in these systems led to stabilization of share ownership, but also to the sterilization of the external capital market as a mechanism for controlling management.

A major change appeared to be about to take place in the early 2000s as a result of the adoption of the 13th Directive in the EU and changes in the Japanese system which encouraged the revival of hostile takeover activity, but a closer inspection also shows that there has been resistance to attempts to institutionalize a market for corporate control. The first significant document in the current round of initiatives was the report of the High Level Group of Experts on takeover bids, published in October 2002. This argued that what the EU needed was 'an integrated capital market' in which 'the regulation of takeover bids [would be] a key element' (High Level Group, 2002a: 18). The report noted that 'the extent to which in a given securities market takeover bids can take place and succeed is determined by a number of factors', including general or structural factors affecting financial markets, and company-specific factors such as rules of company law and articles of association affecting voting rights, protection of minority shareholders, and the legitimacy of takeover defences. It then observed that 'there are many differences between the Member States in terms of such general and company specific factors', with the result that the EU lacked a 'level playing field'.

The substantive content of state-level company laws was also an issue for the High Level Group. The essence of the problem was that the laws of most member states did not sufficiently conform to a model of corporate governance in which managers understood their principal duty to return value to shareholders, and in which takeovers played a crucial disciplinary role in reminding them of this obligation:

> Actual and potential takeover bids are an important means to discipline the management of listed companies with dispersed ownership, who after all are the agents of shareholders. If management is performing poorly or unable to take advantage of wider opportunities the share price will generally under-perform in relation to the company's potential and a rival company and its management will be able to propose an offer based on their assertion of their greater competence. Such discipline of management and reallocation of resources is in the long term in the best interests of all stakeholders, and society at large. These views also form the basis for the Directive (High Level Group, 2002a: 19).

The High Level Group could not have been clearer: they were proposing a measure based on the standard finance-theory or 'principal-agent' view of the role of hostile takeover bids in enhancing shareholder value. The assertion that managers are 'after all' the agents of shareholders is one based on a particular economic-theoretical position, and has no grounding in the legal conceptions of the company that the High Level Group might have looked for in the laws of the Member States. Even UK company law does not go this far; it has not followed the Delaware practice of sometimes referring to duties owed by directors to the shareholders rather than to the company as a separate entity. Be that as it may, it was very largely to the UK that the EU experts looked to fill out the content of the Directive. Even more so than its many predecessors, this draft of the Thirteenth Directive drew on the model of the City Code on Takeovers and Mergers, a text notable for the high level of protection it gives minority shareholders and for its restriction of poison pills and other anti-takeover defences which US law, which is other takeover-friendly, by and large allows (see Deakin and Slinger, 1997).

The High Level Group's second report, in November 2002, struck a similar note in stressing the role of non-executive directors in monitoring management, which is a feature of British and American practice, but is relatively underdeveloped in other member states:

> Good corporate governance requires a strong and balanced board as a monitoring body for the executive management of the company. Executive managers manage the company ultimately on behalf of the shareholders. In companies with dispersed ownership, shareholders are usually unable to closely monitor management, its strategies and its performance for lack of information and resources. The role of non-executive directors in one-tier board structures and supervisory directors in two-tier board structures is to fill this gap between the uninformed shareholders as principals and

the fully informed executive managers as agents by monitoring the agents more closely (High Level Group, 2002b: 59).

Again, the standard finance or 'principal-agent' model was stressed, and a feature of the British and American systems was presented as if it had universal validity. Features of national systems that did not conform to the principal-agent approach, such as the distinctive role of worker directors and community representatives in two-tier boards, were simply shoehorned into the supposedly universal model. The High Level Group's second report set out a series of objectives for reform of corporate governance (among other things) which reflected this point of view, and which were then incorporated into the Commission's Action Plan on company law, with effect from 2003.[xxxi]

What happened next, and in particular the fate of the Thirteenth Directive, is instructive. Although the Directive was eventually adopted, in 2004,[xxxii] this was only after a series of compromises had been agreed, which considerably diluted the draft presented by the Commission in 2002. Contrary to the expectation that the Directive would roll out a liberal-market model of takeover regulation along similar lines to that of the UK's City Code on Mergers and Takeovers, in its final form it allows member states to retain laws which permit multiple voting rights and limit shareholder sovereignty in various ways, such as allowing anti-takeover defences to be put in place in advance of bids.

Some of the derogations in the Thirteenth Directive are transitional; its general thrust is in favour of the principle of one share one vote, and proportionality between investment risks and decision-making powers is clear. However, rather than impose a single model on member states, the Directive can be seen as setting out an ‘experimentalist’ framework for law-making at state level. This was far from being its original objective. However, the result of the rough-hewn compromises, which informed the final text of the Directive, is that the liberalisation of takeover rules can be achieved in one of several different ways, which may take into account specific features of the legal and institutional environments of the different member states.

Both Germany and France have taken advantage of the derogations in the Directive. In Germany, the supervisory board of a listed company has the power to authorise poison pill like defences. In France the board of directors can issue warrants granting new stock to existing shareholders in the face of a hostile takeover bid, subject only to majority shareholder approval at an ordinary meeting. Germany is moving in the direction of a one-share, one-vote rules but this principle is not recognised by most large listed companies in France. Cross-shareholdings in both countries are not as strong as they were. In France, over 40% of shares in the top 40 listed companies (the CAC 40) are now held by overseas pension and mutual funds (mainly based in the UK and US), a considerable shift from just a decade ago. However, in neither country has a market for corporate control, to match the British or American model, yet emerged.

Another significant feature of the Thirteenth Directive is that provision was made for the reformed takeover rules to make provision for information and consultation of employees. An element of employee consultation was present in earlier drafts of this Directive, and the provisions on this issue which were included in the final text are not especially far-reaching, and do not go as far as the laws of a number of member states. However, the Thirteenth Directives set a pattern, in that mandatory employee consultation provisions were then included in other company law directives, including the directive on cross-border mergers, as well as the Societas Europaea (or 'European company') measures (where again there has been a long debate on this issue). This illustrates the complexities involved in translating the principal-agent model of corporate governance into specific legal provisions. The finance theory espoused by the High Level Group finds no room for managerial engagement with employees on issues of corporate governance, regarding it as a qualification to the principle of shareholder-based control of the firm. However, the issue of employee involvement is unavoidable when it comes to legislating at EU level. This is not just because organised labour interests have numerous possibilities for presenting their view when directives are being formulated, but also because the principle of employee consultation in the event of corporate restructurings has come to be recognised, over several decades, as an important point of reference within the EU legal order, as it is embodied in numerous labour law directives as well as in the EU Charter of Fundamental Rights. Thus the inclusion of employee voice rights in the new EU takeover regime is consistent with the wider structure of EU law in the company and labour law fields; although the extent to which these rights provide real countervailing power to that of the capital markets remains to be seen.

3.5 The civil law: Japan

Most large Japanese enterprises are listed companies with (by international standards) a relatively high degree of dispersed ownership. In the immediate post-war decades, cross-shareholdings were common, and indeed were actively deployed as means of limiting the influence of foreign investors. Between the mid-1960s and the mid-1970s the 'stable shareholding ratio' across the listed company sector as a whole, including cross-shareholdings, rose from 47% to 62% (Miyajima and Kuruoki, 2005: 5-6). However, the ratio had declined again to 45% by 1993 and was only 24% in 2003. Cross-shareholdings of the traditional type represented only 7.6% of the total in 2003 compared to 17.6% in 1993 (NLI Research, 2004). Foreign shareholdings have risen from 11.9% of the market in 1996 to 26.7% in 2005 (National Stock Exchanges, 2006). In 2006 around 8% of the first (main) section of the Tokyo stock market, 196 companies in total, were more than 30% owned by overseas investors (TSE, 2007, p.4).

At the same time, large Japanese companies continue to stress their role as social institutions or 'community firms' which provide stable employment to a core of long-term employees, in return for a high level of commitment and identification with the goals of the firm. This tension between the legal form of the enterprise and its changing ownership structure, on the one hand, and its aspect as a social institution, on the other, has recently been thrown into sharp relief by a series of hostile takeover bids.

The most controversial of these was involving the planned takeover of Nippon Broadcasting System (NBS) by the Internet service provider Livedoor, which was launched in February 2005 (see Whittaker and Hayakawa, 2007). NBS had a cross-shareholding agreement with Fuji Television Ltd. that in turn dominated a corporate group, the Fuji-Sankei media conglomerate. Livedoor's intentions were widely interpreted as being based on 'greenmail'. When NBS attempted to issue new stock in order to dilute Livedoor's holdings and frustrate its bid, the courts declared the move unlawful. In granting Livedoor an injunction, the Tokyo District Court ruled as follows:

> It is inappropriate for the board of directors of a publicly listed company, during a contest for control of the company, to take such measures as the issue of new shares with the primary purpose of reducing the stake held by a particular party involved in the dispute, and hence maintain their own control. In principle the board, which is merely the executive organ of the company, should not decide who controls the company, and the issuing of new shares, etc., should only be recognized in special circumstances in which they preserve the interests of the company, or the shareholders overall.

When this judgment was appealed, eventually, to the High Court, it was upheld:

> The issue of new shares, etc., by the directors – who are appointed by the shareholders – for the primary purpose of changing the composition of those who appoint them clearly contravenes the intent of the Commercial Code and in principle should not be allowed. The issue of new shares for the entrenchment of management control cannot be countenanced because the authority of the directors derives from trust placed in them by the owners of the company, the shareholders. The only circumstances in which a new rights issue aimed primarily at protecting management control would not be unfair is when, under special circumstances, it aims to protect the interests of shareholders overall.

However, the High Court also ruled that defensive measures would be potentially legitimate in four situations: greenmail, asset stripping, a leveraged buy-out, and share manipulation. This was an approach based in part on the jurisprudence of the Delaware courts (Milhaupt, 2005). Unable to make a new rights issue, NBS instead lent shares, minus voting rights, to two friendly parties, and Livedoor subsequently agreed to drop its bid. It sold its shares in NBS to Fuji Television, with Fuji Television, in its turn, taking buying around 12% of the shares in Livedoor.

Around the same time, the economics ministry METI and the Ministry of Justice issue takeover guidelines that drew in part on the report of METI's Corporate Value Committee (CVC). The report of the CVC refers to the concept of 'corporate value' in the following terms:

> The price of a company is its corporate value, and corporate value is based on the company's ability to generate profits. The ability to generate profits is based not only on managers' abilities, but is influenced by the quality of human resources of the employees, their commitment to the company, good relations with suppliers and creditors, trust of customers, relationships with the local community, etc. Shareholders select managers for their ability to generate high corporate value, and managers respond to their expectations by raising corporate value through creating good relations with various stakeholders. What is at issue in the case of a hostile takeover is which of the parties - the bidder or the incumbent management - can, through relations with stakeholders, generate higher corporate value.

The Guidelines take a more shareholder-orientated view, referring to corporate value as 'attributes of a corporation, such as earnings power, financial soundness, effectiveness and growth potential, etc., that contribute to shareholder interests'. However, they also recommended giving scope for companies to put anti-takeover defences in place to deal with what could be regarded as opportunitistic or predatory bids. In 2006 a new law, the Financial Instruments and Exchange Law, amending basic securities legislation, came into effect. This introduced a version of the mandatory bid rule: a party purchasing 10% of a company's stock over a three month period would be required to make a public tender offer or be limited to holding no more than one third of the company's issued share capital. In 2006 changes to company law came into effect that formally allowed companies to put in place anti-takeover defences. These include the powers to issue special class shares with limited voting rights or which can be compulsorily repurchased by the company (thereby depriving a potential bidder of its stake), to make rights issues which exclude a bidder, and to issue golden shares which confer certain rights such as the power to appoint directors or restrain voting rights. The latter type of provisions requires two third's majority support from existing shareholders.

The response to these developments has been complex and multi-layered (see Whittaker and Hayakawa, 2007; Buchanan and Deakin, 2007). On the one hand, a large number of companies have put in place takeover defences. By February 2007 197 listed companies had announced anti-takeover strategies of various kinds (Nikkei, 2007). Some large companies, such as Toyota, have strengthened intra-group cross-shareholdings in an attempt to deflect Livedoor-type bids, and others, such as three main steel producers, have announced anti-takeover defence pacts.

At the same time, there has been some resistance to the growing use of anti-takeover defences. One of the main institutional investor bodies, the Pension Fund Association (PFA), has made clear its opposition to takeover defences that do not have the approval of a simple majority of shareholders. The Tokyo Stock Exchange (TSE) has also been hostile to poison pill type defences, seeing them as a barrier to stock market transparency and to accountability. In March 2006 the TSE amended its own guidelines to allow golden shares, after the main employers' federation, the Keidanren, criticized the Exchange's previous opposition to this type of arrangement, but the TSE guidelines continue to stress the need for majority shareholder approval, in line with the PFA position. Further evidence of growing shareholder pressure comes in the form of dividend increases, which in a number of cases, can be traced to activist shareholder pressure in the companies concerned.

Having said that, the current position of Japanese law is a long way from the model of the City Code. Notwithstanding the introduction of a version of the mandatory bid rule, the Japanese position is closer to Delaware law, which permits poison pills, but with a clearer authorization for takeover defence in the face of 'greenmail' or asset restructuring. The concept of 'corporate value' is being distinguished from the US-inspired 'shareholder value' in contemporary debates. Managerial practice, too, continues to prioritise the model of the community firm, with only few exceptions. This statement, made to one of the present authors by the president of a large company in the course of empirical research on Japanese corporate governance during the autumn of 2006 (see Buchanan and Deakin, 2007) is typical of current attitudes:

> I'm not quite sure whether shutting out these sorts of opportunities [i.e. bid approaches] can really be called 'corporate defence'. However - this is a Japanese sort of environment - the fact is that 6,000 people are working in our group and hitherto they have always had a great feeling of confidence and attachment towards the management. Accordingly, with regard to philosophy, even if for the sake of argument someone were

> to appear with a philosophy that was even more elevated than ours, I would be very worried and doubtful as to whether these employees who are currently contributing their confidence and attachment to us would continue to do so in the same way for them.

3.6 Takeover regulation in emerging and transition systems

In the economies of the common law world, there is growing evidence of shareholder rent extraction. A curious effect of successive takeover waves from the 1970s onwards is that, in Britain and America, the net contribution of new equity to the financing of the corporate sector *as a whole* has become *negative*. This is the result of share buy-backs and the 'retirement' of capital following mergers. The phenomenon has led to questioning of the sustainability of the current model from within the business school community, as in Allen Kennedy's afterword to his 2000 book *The End of Shareholder Value*:

> How many companies would spend their wealth on stock buyback programs if their objective was to create wealth? How many companies would see fit to cut R&D expenditures if their objective was to build wealth? How many companies would caverlierly shed long-term, loyal employees, their heads crammed full of information valuable to the company, if their objective was to create wealth?

In a similar vein, Marjorie Kelly (2001), writing in the pages of the *Harvard Business Review*, argued that:

> stock-market investors have become, collectively, an extraordinarily unproductive force in business. Indeed, for the last two decades, their contribution to corporations has been literally negative… it's wrong to shovel money out to shareholders in ever larger scoops and force other stakeholders to pay the price.

Shareholders' role is no longer simply to *supply finance* to companies. Most trades of shares in listed companies consist of movements from one shareholder to another with no new capital being supplied to the company. Rather, as agency theory prescribes, the function of shareholders is to *discipline* corporate management. Thanks to the takeover revolution and the changes associated with it, the managers of listed companies must maintain shareholder approval. If they do not, they face the prospect of a takeover bid. In practice, this means that companies have to satisfy, on a continuing basis, shareholders' expectations for high rates of return on equity. If they can do this, a rising share price becomes an asset in its own right, which can be deployed to fund growth through acquisitions (Millon, 2002).

The position is, however, different in civil law systems and in the developing world. The net contribution of equity capital has been positive in those systems that have not followed the Anglo-American shareholder primacy norm: mainland Europe, Japan, and developing world economies such as Brazil and India (Singh, Singh and Weisse, 2002).

Is this going to change as a result of shifts in takeover regulation in developing and transition economies? One of the central features of the British (and now, to a degree, the EU) model is the mandatory bid rule. This is at the core of the City Code system, which aims to protect the right of minority shareholders to access, in proportion to their holdings, the surplus generated by a takeover bid. It is an important stimulus to the fragmentation and dispersion of ownership while also discouraging the construction of cross-shareholdings. Influenced by a mixture of British and EU practice, many systems have adapted a version of the mandatory bid rule in the past ten years as part of a general realignment of takeover regulation in favour of the protection of minority shareholder interests: 1987 in Malaysia, 1994 in India, 2000 in Pakistan, 2000 in Chile, 2002 in Argentina, 2005 in Mexico (Siems, 2007).

A similar trend can be observed in transition systems as a result of the adoption of the Thirteenth Company Law Directive (Commission, 2007). Two important aspects of the Directive are the 'board neutrality rule', which limits the scope for takeover defences both ex ante and during a bid, and the 'breakthrough rule' under which poison pills and golden shares can be overridden during a bid. Most western European systems have taken up the opportunity provided by the Directive to derogate from both these rules, but the rate of take up of derogations is lowest in the Central and Eastern European (CEE) countries which constitute the 'accession' member states: the board neutrality rule has been adopted in the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Slovakia and Slovenia, and the breakthrough rule has been adopted in Estonia, Latvia and Lithuania. Of the CEE accession states, only Poland has followed the lead of Germany and other western European countries in rejecting both the breakthrough rule and the board neutrality rule. This suggests that the approach which began in the City Code is on the way to becoming a global standard. Is this in the long-run interests of developing and transition systems?

4. The Economist's view of the Market for Corporate Control

From a discussion of the alternative legal approaches to the question of takeover bids, we now turn to economic analysis. In terms of the language of the agency theory and the theory of asymmetric information, the central issue may be stated in the following terms. The modern corporations are, it is suggested, characterised by serious principal-agent problems, particularly between shareholders (principals) and managers (agents); asymmetric information between the two; as well as incomplete contracting. The operation of these factors provides analytical justification for the proposition that managers have scope to pursue their own ends.

One branch of the literature has pointed to the difficulties involved in limiting managerial discretion through a more rigorous analysis of corporate governance, ie. the internal governance mechanisms of the corporation, including shareholder voting and the effectiveness of board of directors. The alternative means available to the shareholders to limit such discretion is to attempt to align managers' interests with their own by devising appropriate incentive contracts. All such efforts, however, have a cost (the so called 'agency cost'). Within the framework of these concepts, the takeover selection argument can then be deployed in two ways. The strong form would suggest that only firms that are able to devise and implement optimal incentive contracts would be selected for survival; others will be taken over. In a weaker form, this theory would propose that, since in the real world substantial agency costs are inevitable and it is not always possible to design satisfactory incentive contracts, the takeover mechanism, nevertheless, helps to reduce agency costs and thus promote economic efficiency. The implication of this weaker proposition is that, other things being equal, the greater the agency costs, the more likely it is that the firm will be taken over.

In this paradigm, in normative terms, the free operation of the takeover mechanism can benefit society through two distinct channels: (a) the *threat* of takeovers can discipline inefficient managements and reduce 'agency costs'; (b) even if the firms were working efficiently, takeovers may lead to a reorganisation of their productive resources and thereby enhance shareholder value.

There is a sharp dispute between industrial organisation economists and specialists in finance about the efficiency of mergers and takeovers. The former believe that takeovers do not lead to increased efficiency; at best they are neutral, but most likely they reduce efficiency. The industrial organisation economists use accounting data to arrive at this conclusion (Scherer, 2006; Mueller, 2003). This leads these economists to advocate regulation of mergers since they are likely to enhance monopoly power of the amalgamating firms without, on average, increasing their efficiency. In contrast, the finance specialists believe, on the basis of stock market data and events studies methodology, that mergers enhance economic and social efficiency. These scholars are therefore opposed to regulation of mergers. A leading exponent of this view is Professor Jensen (2005). He and his colleagues regard anti-takeover legislation, which as mentioned before, many individual American states have instituted in reaction to the successive huge merger waves of the last three decades, as being misconceived and promoted by special interests. Some scholars belonging to this school would go even further. They not only oppose any new anti-merger regulatory measures, but also suggest that the extant institutional obstacles to takeovers should be eliminated. There are at present a number of stock exchange provisions both in the US and the UK whose main purpose is to afford protection to minority shareholders and to ensure 'fair play' and transparency in share transactions connected with the takeover process. For example, in the UK, a corporate raider is obliged to disclose its stake in the victim company after it has purchased 3 per cent. of the victim's shares. Moreover, the raider is required to make a full cash bid for all the shares of the company after it has purchased 30 per cent. of the victim's stock. The exponents of the market for corporate control believe that such regulations constitute imperfections in the free functioning of the market; they are, therefore, ipso facto inefficient, and hence should be removed.

This very positive finance specialists' view of the market for corporate control is vigorously contested by industrial organization economists. Their reservations are best conveyed by a critical analysis of the US business model of shareholder wealth maximization subject to the constraints of liquid stock markets (including the takeover mechanism). This model is being promoted for emerging countries by the IMF and the World Bank, and indeed is recommended as a universal standard for the whole world by these institutions and orthodox policy makers. Ironically, as we shall see below, this model has risen from the shadow of strong criticism less than 15 years ago, when it was held responsible for the sluggishness of the US economy, to its current acclaim for having engineered the US lead in the information and technology revolution and for fostering faster growth in the US economy.[xxxiii] The extent to which the US corporate model facilitates technological dynamism is perhaps the central issue in any assessment of its merits.

However, it is now accepted that since 1995 there has been an increase in the US economy's long-term rate of growth by perhaps as much as one percentage point, from 2.5 to nearly 3.5 per cent. per annum. This strong performance is attributed by leading scholars such as Jorgenson (2001, 2003) to the US lead in information technology. This success, in turn, is attributed by many economists, and particularly, by the media to the pivotal role played by US stock markets and venture capital markets in financing this technological revolution[xxxiv]. It is suggested that not all economies with stock markets are able to achieve these feats. Black and Gilson (1998) have argued that other advanced economies such as Germany have tried to imitate the US venture capital market but have not been successful. The American success is due in part to its having a highly efficient and effective market for corporate control. This allows a timely 'exit option', making it possible for the American-type venture market to flourish. There are also other advantages attributed to the US stock market, as, for example, the widespread use of stock options in technology industries that bring individual manager's incentives in line with corporate objectives.

Larry Summers (1998, 1999), who in the past has been critical of the short-term focus of the stock market, has changed his mind. He now suggests that the increasing stock-market pressure for performance has played a key role in the US economic success of the last decade. Further, the huge investment in new technology firms in the US during the technology boom of the 1990s, despite their zero or negative short-term profits, is regarded as an obvious refutation of the short-termism alleged by critics of stock markets (however, see below).

Nevertheless, taking into account the above facts, a critical examination of the functioning of the stock market in the last ten years raises the following questions. Does the experience of the last decade warrant a complete reversal of the conclusions reached by Michael Porter and his colleagues in 1992? Does the so-called 'new' US economy constitute a conclusive proof of the superiority of the country's financial system over all others'? Is there adequate analysis and empirical evidence to indicate that the Anglo-Saxon model of corporate governance outlined above is the one that all countries, including developing ones, should adopt? Singh et al (2005) have carried out a detailed analysis of these issues and they report the following conclusions:

- The experience over the last decades in the US capital markets provides little justification for revising the unfavourable 1992 verdict of Michael Porter and his colleagues, although the reasons for this are not necessarily the same now as they were then.

- Instead of maximizing shareholder wealth, developing country companies should pay no attention to their market valuations. Rather, they should pursue their traditional objective of increasing market share or corporate growth within the overall framework of the country's industrial policy.

- The stock-market based model of shareholder wealth maximization does not represent the 'end of history' or the epitomy of corporate law as some suggest.

The main reasons for these conclusions lie in the severe deficiencies of two market processes, which are central to the efficient operation of stock markets, first the pricing process and second the market for corporate control. It will further be appreciated that the last decade of applause for the US stock market must at least be tempered by the fact during this period there was not only a boom but also a very significant bust. The NSDAQ index of share prices of new technology companies is still well below half the value that it reached at its peak in 2000.

5. Stock Market Prices and the Market for Corporate Control

5.1 The pricing process on the stock market

It will be observed that during the last two decades the orthodox efficient markets hypothesis concerning share prices has suffered fundamental setbacks. These are specifically due to the following events: (a) the 1987 US stock market crash, (b) the meltdown in the Asian stock markets in the late 1990s and (c) the bursting of the technology stocks bubble in 2001. Following Tobin (1984) a useful distinction may made between two kinds of efficiency of stock markets. First, there is 'information arbitrage efficiency' (IAE) which ensures that all information concerning a firm's shares immediately percolates to all stock market participants, ensuring that no participant can make a profit on such public information. Second, there is 'fundamental valuation efficiency' (FVE), that is, share prices accurately reflect a firm's fundamentals, that is, its long-term expected profitability (Tobin, 1984). The growing consensus view is that stock market prices may at best be regarded as efficient in the first sense above (IAE), but are far from being efficient in the economically more important second sense (FVE; Singh, 1999) This point hardly needs labouring today in the light of the burst of the technology bubble in leading stock markets in 2001 and almost two decades of stock market stagnation and decline in Japan. It will be difficult to preach an EMH gospel to citizens in Thailand and Indonesia who suffered a virtual meltdown of their stock markets during the Asian crisis of 1997-1999 (see further Singh et al. 2005).

5.2 The market for corporate control as an evolutionary mechanism[xxxv]

There are good theoretical reasons as well as a large body of empirical evidence to suggest why the markets for corporate control in advanced countries, including the UK and the US, do not work at all well. A central point of this research is that the take-over selection process does not simply punish poor performance and reward good performance. The evidence indicates that selection in this market does not take place entirely on the basis of performance but much more so on the basis of size. A large relatively inefficient firm has a greater chance of survival than a small efficient firm (Singh, 2008).

Further, there are good theoretical reasons as well as empirical evidence for suggesting that take-overs may lead to 'short-termism', and/or speculative buying and selling of shares. In addition, more broadly, they may also result in economic rewards being given for financial engineering rather than for entrepreneurial effort in improving products and cutting costs. Empirical research indicates that the take-over disciplinary process is very noisy and is often arbitrary and haphazard (Ravenscraft and Scherer, 1987; Scherer, 1998, 2006; Tichy, 2001; Singh 2000). The deficiencies of the pricing and takeover processes are compounded in the case of developing countries because of their regulatory deficits and relative immaturity of their stock markets. Singh (1998) argues for restrictions on the development of a market for corporate control for these countries. Rather, he suggests that developing countries should find cheaper and less haphazard mechanisms to change managements than the above stock market process.

5.3 The technology boom, the mispricing of shares and the market for corporate control

It is generally accepted that there was a widespread mispricing of shares during the technology boom of 1995-2000. There was also a huge over-investment in technology companies. Importantly, in addition to the foregoing there was also evidence of significant resource misallocation through the working of the market for corporate control. In essence grossly overpriced technology companies bought up underpriced old economy companies to the detriment of both and to the detriment of social welfare. Jensen (2003) drew attention in this context to the case of Nortel, a large US company that between 1997 and 2001 acquired 19 companies at a price of US$ 33 billion. Many of these acquisitions were paid for in Nortel shares whose value had skyrocketed during that period. When the company's price fell 95 per cent in the technology stock burst, all the acquisitions had to be written off. Jensen observed 'Nortel destroyed those companies and in doing so destroyed not only the corporate value that the acquired companies - on their own - could have generated but also the social value those companies represented in the form of jobs, products and services.' (pp.15)

Although Jensen suggests various ways of reducing the mispricing of shares, in Keynesian analysis such mispricing is inherent in any asset valuation pricing process via the stock market. In this paradigm, stock market players base their investment decisions not on the basis of fundamentals but on speculative and gambling considerations. With such pricing, shareholder wealth maximization is clearly not a useful objective for corporate managers who have the firm's interest in view. Kay (2003) therefore rightly suggests that corporate managers should pay no attention to the stock market at all. Indeed, the creation of shareholder value should not be a corporate goal. The Keynesian view of pricing process is supported by a large body of analytical and empirical studies: see for example Shiller (2000) and (2004), Schleifer (2000).

6. Conclusion

In orthodox economic analysis, the market for cooperate control is thought to be the evolutionary endpoint of stock market development. This proposition has been seriously questioned in this paper from the perspective of both legal and economic analysis.

Takeovers are a very expensive way of changing management. There are huge transactions costs associated with takeovers in countries like the US and UK, which hinder the efficiency of the takeover mechanism (Peacock and Bannock, 1991). Given the lower income levels in developing countries, these costs are likely to be proportionally heavier in these countries. It may also be observed that highly successful countries overall, such as Japan, Germany and France, have not had an active market for corporate control and have thus avoided these costs, while still maintaining systems for disciplining managers. Significantly, the lack of a market for cooperate control has not imposed any great hardship on these economies as their superior long-term economic record say over the last 50 or a 100 years, compared with that of Anglo-Saxon countries, indicates. Furthermore, there is no evidence that corporate governance necessarily improves after takeovers. This is for the simple reason that all takeovers are not disciplinary; in many of them the acquiring firm is motivated by empire-building considerations or indeed by asset-stripping.

In summary, contrary to current conventional wisdom, an active market for corporate control is not an essential ingredient of either company law reform or financial and economic development. The economic and social costs associated with restructuring driven by hostile takeover bids, which are increasingly seen as prohibitive in the liberal market economies, would most likely harm the prospects for growth in developing and transitional systems. Developing countries simply cannot afford the burden of the extremely expensive, and hit and miss system of management change that takeovers represent.

The following argument might be raised against the claims that we have made here: if two mechanisms were available, an internal one based on corporate governance and an external one, represented by take-overs, why not use them both to improve corporate performance? One immediate difficulty with this argument is that acquiring companies may themselves be empire builders rather than disciplining shareholder value maximisers, as was noted above. It was also seen that at a more macro-economic level, take-over mechanism may subvert capitalist values by rewarding financial engineering rather than enterprise. In a survey carried out by Cosh, Hughes and Singh, in the 1980's, it was found that 60% of the time of the Chief Executives of Britain's top companies was spent on road shows to investors, rather than promoting new products or reducing costs, the essential tasks of enterprise. The three authors also found that a great deal of time was spent by the Chief Executives and Financial Director in either avoiding take-overs or trying to take over other companies themselves (Cosh, Hughes and Singh,1990).

Perhaps our suggestion that developing country corporations should pay no attention to their market valuations is somewhat extreme. But our essential argument here is that stock market valuations are a highly inaccurate guide to the fundamental valuations of companies. This is especially so in developing countries where theory predicts that the share price volatility is even greater than advanced countries. With the kind of meltdown in share prices, observed in East Asia during the crisis years of 1997-1999, it was scarcely useful to ask corporations to judge their performance by changes in share prices. As mispricing of shares cannot be forecast with any accuracy, and as historical evidence suggests, such mispricing may continue over long periods of time, it does not auger well for companies to use stock market values as the main criteria for judging success or failure.

Finally, it could be argued against us that all we have offered here is a critique, when what is needed are practical answers to the question of how to design institutions for the market for corporate control. A clear conclusion of our argument is that the mandatory bid rule and other similar aspects of the UK model, which are now being very widely exported around the world, will not aid the cause of economic development, we do not favour these rules. This does not mean that takeovers should be entirely unregulated – far from it. Not only developing countries but also those in Continental Europe, which have long operated without a market for corporate control, should seek alternative institutional mechanisms for disciplining errant managements than to adopt the Anglo-Saxon take-over mechanism. Instead of concentrating on shareholder value, these countries should be actively promoting new institutional mechanisms for inclusive development of the company and its diverse constituencies.

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[ii] This part updates, in part, material first set out in Deakin et al. (1997) and (2002), and draws on Deakin (2008).

[iii.] *Unocal* v. *Mesa Petroleum* 493 A.2d 946, 955 (1985).

[iv.] *Revlon Inc*. v. *McAndrews & Forbes Holdings Inc.* 506 A.2d 173 (1986); *Paramount Communications Inc.* v. *QVC Network Inc.* 637 A.2d 34 (1994).

[v.] *Paramount Communications Inc.* v. *Time Inc.* 571 A.2d 1140 (1989). On Delaware's `zig-zags', see Roe, (1993), and Blair, 1995: 220-222.

[vi.] 457 US 624 (1985).

[vii.] 481 US 69 (1987).

[viii.] *Schreiber* v. *Burlington Northern Inc.* 475 US 1 (1985).

[ix] Directive 2004/25/EC of the European Parliament and the Council of 21 April 2004 on Takeover Bids, L 142 Official Journal of the European Union 30.4.2004).

[x] The Takeovers Directive (Interim Implementation) Regulations 2006 (SI 2006/1183), which came into force on 20 May 2006, provide a statutory basis for the Panel's operation, and empower it to issue rules on takeover bids. These Regulations have more recently been superseded by relevant provisions of the Companies Act 2006.

[xi] See DTI, 2005, and Takeover Panel, 2005.

[xii] City Code, General Principle 1.1.

[xiii] Ibid., rule 9. See also Companies Act 1985, s. 430A providing a statutory right to sell where the bidder and its associates control 90% in value of the relevant shares; s. 428 grants the bidder a right of compulsory purchase of the last 10% of shares.

[xiv] City Code, rule 36.

[xv] City Code., rule 20.1.

[xvi] Ibid., rule 3.1.

[xvii] Ibid., rule 25.1(a).

[xviii] Ibid., rule 19.2.

[xix] A claim in tort might well be made out notwithstanding the restrictive decision of the House of Lords (on auditor liability) in Caparo Industries plc v. Dickman [1990] 2 AC 6, and it is also possible that directors who provide misleading advice on the sale of shares may commit a breach of statutory duty actionable by the shareholders: Gething v. Kilner [1972] 1 All ER 1166.

[xx] Heron International Ltd. v. Grade [1983] BCLC 244.

[xxi] General Principle 3.

[xxii] City Code, rule 24.1.

[xxiii] Ibid, rule 25.1(b).

[xxiv] See below, section 3.

[xxv] City Code, rule 30.2(b). This is however subject to the target board receiving the employee representatives' views in good time, which may not always be straightforward. See Takeover Panel 2006: 32-3, for discussion.

[xxvi] City Code, rule 21.

[xxvii] See *Howard Smith Ltd.* v. *Ampol Petroleum Ltd.* [1974] AC 821, discussed by Parkinson, 1993: 143.

[xxviii] Companies Act 1985, ss. 85-89.

[xxix] These Guidelines were first issued on 21 October 1987 by the International Stock Exchange's Pre-emption Group, consisting of members of the ISE and officers of the principal representatives of institutional shareholders, namely the Association of British Insurers and the National Association of Pension Funds. Under Guideline 1.2, the Investment Committees of the ABI and NAPF agreed to advise their members, under normal circumstances, to approve resolutions for annual disapplication of pre-emption rights, as long as the non pre-emptive issue did not exceed 5% of the issued ordinary share capital as shown in the most recent published accounts of the company.

[xxx] Guidelines published by the Institutional Shareholders Committee (a body representing a number of financial industry interests and trade associations) in December 1991, The Responsibilities of Institutional Shareholders in the UK, stated that 'institutional shareholders have for many years been opposed to the creation of equity shares which do not carry full voting rights and have sought the enfranchisement of existing restricted voting or non-voting shares' (para. 3).

[xxxi] See High Level Group, 2002a: 10-12. On the Action Plan, and its development since 2002, see Commission, 2003, and the company law website of the Internal Market Directorate: http://ec.europa.eu/internal_market/company/index_en.htm.

[xxxii] Directive 2004/25/EC.

[xxxiii] Porter (1992) reported on the findings of a US blue ribbon commission (comprising 22 leading US economists including Larry Summers) on the country's business model and the associated system of allocating capital. The Commission made serious criticisms of

America's capital markets, indicating that they were misallocating resources and jeopardizing the American position in the world economy. It is indeed true that the US economy stagnated between 1973 and 1995, registering hardly any overall increase in productivity growth.

[xxxiv] This is not necessarily Professor Jorgenson's view. He attributes the rapid uptake of information technology in the US to the sharp fall in the price of semiconductors as a result of increased competition. This in turn arose from a reduction in the product cycle from 3 to 2 years.

[xxxv] This section is based on, and updates some of my previous contribution in this area including Singh (1992, 2000, 2006)