

# HOSTILE TAKEOVERS AND DEFENSIVE MECHANISMS IN THE UNITED KINGDOM AND THE UNITED STATES: A CASE AGAINST THE UNITED STATES REGIME

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*The United States and the United Kingdom are two countries sharing the same belief in the free market economy. Both countries are characterized by the separation of ownership and control and hostile takeovers are an important mechanism for constraining managerial excesses. However, the regulation of takeovers and defensive mechanisms is strikingly different. While Delaware jurisprudence has entrusted the board with the power to block hostile bids subject to an enhanced judicial standard, the United Kingdom has been a pioneer in adopting and promoting across Europe an absolute ban on takeover defenses. The public outrage provoked by the recent Kraft-Cadbury debacle has increased calls for stricter regulation of hostile takeovers. In light of the growing skepticism against the City Code's lenient approach to hostile takeovers, a question naturally arises. Should the United Kingdom abandon its restrictive approach towards takeover defenses and adopt the laxer and more lenient U.S. model? The answer should be negative, as the implementation of a U.S.-style regime, under which directors' defensive actions are scrutinized by the courts, would result in the U.K. market losing its major advantages. The speed, flexibility and certainty offered by the current regime would dissipate, should the authority in regulating defensive tactics be given to the courts. The genius of the U.K. regime lies in its ability to achieve the best results at a minimum cost. It manages to promote certainty, a vibrant takeover market and the accountability of directors, while eliminating the costs generated by litigation. In addition, the costs imposed by Rule 21 of the Takeover Code are either insignificant or associated with a wider debate outside the takeover field.*

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## I. INTRODUCTION

The continuous growth of the financial sector and its ability to channel large amounts of funds in a short time have led to the constant rise of merger and acquisition (M&A) activity. Despite the decrease in the number and price of deals caused by the recent financial crisis and the ongoing sovereign debt crisis,<sup>1</sup> M&A activity will continue to thrive, acting as a key mechanism in the integration of markets. Although hostile takeovers account for a relatively small percentage of total takeovers,<sup>2</sup> it is this transaction that shocked the traditional consensus business culture in the United Kingdom and the United States. Entrepreneurs, such as Sir James Goldsmith in the United Kingdom and Carl Icahn in the United States, succeeded in establishing hostile takeovers as a control-shifting transaction in a previously unfavorable market environment.<sup>3</sup> The furious U.S. takeover battles of the 1980s drew the attention of the public and raised wide concerns about the desirability of hostile takeovers.<sup>4</sup> Nonetheless, the collapse of Drexel Burnham Lambert, an investment bank specializing in financing takeovers through the issuance of junk bonds, and the subsequent demise of the junk bond market severely restrained the ability of raiders to fund takeovers. Thus, the era of the aggressive takeover, when raiders sought to strip the company of its assets and make a quick profit out of a fire sale, has gone. Hostile takeovers are now viewed as a perfectly legitimate weapon for overcoming resistance by the target's management. Indeed, the European Union, in adopting Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids (Takeover Directive or Directive),<sup>5</sup> has firmly expressed its support towards a vibrant and dynamic takeover market. Additionally, hostile takeovers have begun to spread in continental Europe,

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<sup>1</sup> Zachary R. Mider et al., *M&A Slumps to Lowest Level Since Financial Crisis's Nadir*, BLOOMBERG (Sept. 27, 2012, 12:01 AM), <http://www.bloomberg.com/news/2012-09-27/m-a-slumps-to-lowest-level-since-financial-crisis-s-nadir.html>.

<sup>2</sup> For instance, since 1998, hostile takeovers have accounted for nearly fifteen percent of M&A transactions. Michael Erman, *DEALTALK-Hostile Bids Set to Rise Again in 2011*, REUTERS (Jan. 6, 2011, 6:34 PM), <http://www.reuters.com/article/2011/01/06/dealtalk-hostiles-idUSN0610526120110106>.

<sup>3</sup> See Stanley Penn, *Raiding Parties: Friends and Relatives Hitch Their Wagon to Carl Icahn's Star*, WALL ST. J., Oct. 2, 1985; Joann S. Lublin, *With U.S. Takeovers Grown Expensive, Sir James Goldsmith Looks to Britain*, WALL ST. J., Mar. 7, 1989.

<sup>4</sup> See generally KNIGHTS, RAIDERS, AND TARGETS (John C. Coffee, Jr. et al. eds., 1988).

<sup>5</sup> Directive 2004/25, 2004 O.J. (L 142) 12 (EC).

most notably in Germany. Following the celebrated takeover of Mannesmann by Vodafone,<sup>6</sup> even the traditionally closed German corporate system, commonly referred to as ‘Deutschland A.G.,’ has become more open to takeovers.

The term “hostile takeover” refers to a takeover offer which is launched either without its prior communication to the target’s management or without the latter’s consent to it. In the United Kingdom, the hostile takeover made its appearance in the 1950s and was met with strong opposition from directors. The magnitude of the threats posed by an unregulated takeover regime led to the adoption of the City Code on Takeovers and Mergers (Takeover Code or Code),<sup>7</sup> which from its first version promoted an active takeover market by prohibiting the target’s management from erecting post-bid defenses. In fact, the Takeover Code was the model on the basis of which the European Takeover Directive was formulated. Thereupon, the changes to the Takeover Code necessary to implement the Takeover Directive were minimal. Nonetheless, the Takeover Directive required the United Kingdom to ground the Takeover Panel on a statutory basis. The U.K. government succeeded in including provisions in the Takeover Directive, which guaranteed that the advantages of the previous self-regulatory regime would not be undermined. Overall, the United Kingdom has clearly voted in favor of a shareholder choice approach. The decision on whether a hostile takeover bid will succeed is one for the shareholders to take. The board should not intervene in the takeover battle unless shareholders authorize the implementation of defensive measures. Taking into account the similar structure of the U.S. corporate system<sup>8</sup> and the frequent use of the hostile takeover, one would

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<sup>6</sup> For a detailed analysis of the Vodafone-Mannesmann takeover and its implications for German corporate governance see Martin Höpner & Gregory Jackson, Discussion Paper, *An Emerging Market for Corporate Control? The Mannesmann Takeover and German Corporate Governance*, 01/4 (Max Planck Inst. for the Study of Soc’y, Discussion Paper 01/4, 2001).

<sup>7</sup> THE PANEL ON TAKEOVERS & MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS (THE CODE) (11th ed. 2013) [hereinafter THE TAKEOVER CODE]

<sup>8</sup> The U.S. and U.K. corporate systems are characterized by the wide dispersion of shareholdings. Each individual shareholder owns a small fraction of the total share capital. Due to coordination costs and free-rider problems, shareholders are unable to effectively monitor management. One should note, however, that dispersed ownership corporate systems are the exception rather than the rule. The majority of corporate systems around the world, such as in Continental Europe and Asia, are characterized by the concentration of shareholdings in the hands of a single investor, usually an individual, a family or another corporation. See generally Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117 (2007); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

expect that the approach adopted would be similar—that is an approach of strict board neutrality. However, directors and not shareholders are the main actors in a U.S. takeover battle. The board is allowed to resort to a variety of defensive mechanisms reviewed by the courts on the basis of a flexible business judgment rule.

The recent hostile acquisition of Cadbury, an iconic British brand, by U.S.-based Kraft sparked a wider debate in the United Kingdom concerning the vulnerability of U.K. companies to hostile acquisitions by foreign acquirers.<sup>9</sup> Various commentators, including journalists and politicians, expressed their skepticism against the Takeover Code's laissez-faire approach and argued that the Takeover Code had unacceptably tilted the balance in favor of hostile acquirers.<sup>10</sup> In response to the public outrage and backlash from Cadbury's hostile takeover, the Takeover Panel (Panel) initiated a review of the Takeover Code. Recognizing that hostile bidders had been able to secure a tactical advantage vis-à-vis target companies, the Takeover Panel introduced amendments to the Takeover Code aimed at redressing the balance of power between bidders and targets.<sup>11</sup>

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<sup>9</sup> Kraft, a U.S. food company, launched its hostile takeover bid for Cadbury, an iconic U.K. confectionary business, on September 7, 2007. The board of Cadbury immediately rejected the offer as inadequate and initiated a campaign against the takeover. After a fierce takeover battle, Cadbury accepted Kraft's bid on January 19, 2010. Controversy ensued as a result of the accumulation of Cadbury stock by hedge funds and other short-term arbitrageurs eager to quickly sell their positions for any premium without any regard to the fundamental value of the company, and Kraft's reversal of its promise at the beginning of the takeover battle to keep Cadbury's Somerdale plant near Bristol open. See Scott Moeller, *Case Study: Kraft's Takeover of Cadbury*, FT.COM (Jan. 9, 2012, 7:55 PM), <http://www.ft.com/intl/cms/s/0/1cb06d30-332f-11e1-a51e-00144feabdc0.html#axzz2Wi0d5lgO>; Zoe Wood, *Takeover Panel to Look into Kraft's Closure of Cadbury Factory*, THEGUARDIAN.COM (Mar. 8, 2010, 1:00 PM), <http://www.guardian.co.uk/business/2010/mar/08/kraft-cadbury-closure-takeover-panel>.

<sup>10</sup> See Louise Lucas & Alan Rappeport, *Mergers and Acquisitions: A Bitter Taste*, FT.COM (May 23, 2011, 9:04 PM), <http://www.ft.com/intl/cms/s/0/03559624-8571-11e0-ae32-00144feabdc0.html#axzz2TDcwwyog>; Tim Webb & Julia Kollwe, *Vince Cable Bids to Overhaul City Takeover Regime*, THEGUARDIAN.COM (July 19, 2010, 12:16 PM), <http://www.guardian.co.uk/business/2010/jul/19/vince-cable-overhaul-city-takeover>; Amy Wilson & James Quinn, *Kraft Moves Fast to Silence the Doubters*, THE TELEGRAPH.COM (Jan. 23, 2010, 9:00 PM), <http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/7061041/Kraft-moves-fast-to-silence-the-doubters.html>.

<sup>11</sup> THE CODE COMMITTEE OF THE TAKEOVER PANEL, REVIEW OF CERTAIN ASPECTS OF THE REGULATION OF TAKEOVER BIDS, PROPOSED AMENDMENTS TO THE TAKEOVER CODE (2011); THE CODE COMMITTEE OF THE TAKEOVER PANEL,

The aim of this article is to provide a detailed analysis of the regulation of takeover defenses in the United Kingdom. An examination of the U.S. regime will reveal the striking differences between these two regulatory models. In light of the growing skepticism against the Takeover Code's lenient approach to hostile takeovers, a question naturally arises. Should the United Kingdom abandon its restrictive approach towards takeover defenses and adopt the laxer and more lenient U.S. model? The answer should be negative, as the implementation of a U.S.-style regime, under which directors' defensive actions are scrutinized by the courts, would result in the U.K. market losing its major advantages. The speed, flexibility and certainty offered by the current regime would dissipate should the authority in regulating defensive tactics be given to the courts.

The present article will proceed as follows: in Part II, we will discuss the theoretical framework, which has given support to the hostile takeover, and briefly describe the source of takeover regulation in the United Kingdom, namely the Takeover Code and its background. The impact of the Takeover Directive will also be considered. Part III analyzes some common defensive measures evolved mainly in the United States. These include: the infamous "poison pill," staggered boards and "white squires." Parts IV and V will examine the U.K. regulation of pre-bid and post-bid defenses, respectively. Only post-bid defenses fall within the ambit of Rule 21 of the Takeover Code. The duty of a director to promote the success of the company and the duty to act for proper purposes are the only restraints on pre-bid defenses. Part V will also review the rationale behind the total prohibition of post-bid defenses. In Part VI, we will contrast the U.K. with the U.S. regime and reveal their striking differences, both in terms of law and philosophy. Finally, we will endeavor to support our argument against the adoption of the U.S. regulatory model in the United

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REVIEW OF CERTAIN ASPECTS OF THE REGULATION OF TAKEOVER BIDS (2010). Although the Panel refrained from adopting far-reaching proposals to raise the minimum acceptance threshold for an offer to succeed from the current "fifty percent plus one" of the voting rights in the target company to sixty-six percent or two thirds of the voting rights and disenfranchising shares acquired during the offer period, the new amendments will significantly change the nature and process of dealmaking in the United Kingdom. Most notably, the amended Takeover Code bans deal-protection devices such as break fees except for limited circumstances and protects companies against so-called "virtual bids" by requiring any publicly named bidder, within four weeks, either to announce its firm intention to proceed with an offer or walk away without making an offer. For an overview of the changes to the Takeover Code, see Memorandum from Michael E. Hatchard & Scott C. Hopkins, *U.K. Takeover Code — Changes Effective September 19, 2011*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, (Sept. 21, 2011) [http://www.skadden.com/newsletters/UK\\_Takeover\\_Code\\_Changes\\_Effective\\_September\\_19\\_2011.pdf](http://www.skadden.com/newsletters/UK_Takeover_Code_Changes_Effective_September_19_2011.pdf).

Kingdom.

## II. THE THEORETICAL FRAMEWORK AND TAKEOVER REGULATION IN THE UNITED KINGDOM

### *A. The Conventional Wisdom and the Market for Corporate Control*

A vast amount of literature revolving around the motives of takeovers has developed during the past years.<sup>12</sup> A common explanation of takeovers is the achievement of synergy gains. The two companies will have a higher value combined than separately. The gains will be generated through the accomplishment of economies of scale. In the case of economies of scale, the value is created by spreading costs over an increased output. Moreover, the combined enterprise will be able to obtain funds from banks or the capital markets more cheaply due to its size and strength. Another possible motive behind takeovers is the need for diversification. Accordingly, an acquisition of another company is seen as a means of spreading risk. Nonetheless, it has been argued that diversification of companies is useless, mainly because shareholders may reduce risk by diversifying their own portfolios at a lower cost.<sup>13</sup>

However, takeovers may not always be driven by a sheer desire to generate value but by managerial self-interest. Managers may engage in a series of acquisitions for the purpose of maximizing their reputation and power (empire building).<sup>14</sup> The creation of monopoly power and the consequential expropriation of consumers used to be another traditional explanation of takeovers. Nevertheless, in the present legal regime, the creation of monopolies is strictly prohibited by competition laws. In addition, this theory does not explain why takeovers of companies in other lines of business occur.<sup>15</sup>

In his famous article, *Mergers and the Market for Corporate Control*,<sup>16</sup> Manne put forward a different explanation of takeovers. Takeovers are the result of the function of the market for corporate control.

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<sup>12</sup> For an excellent overview, see Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 YALE J. ON REG. 119 (1992).

<sup>13</sup> TERENCE E. COOKE, *MERGERS AND ACQUISITIONS* 33 (1986).

<sup>14</sup> See Klaus Gugler et al., *The Determinants of Merger Waves* (Soc. Sci. Research Ctr. Mkts. & Politics, Working Paper No. SP II 2006-01, 2006) (suggesting that merger waves are driven by managerial empire building). See generally Robin Marris, *A Model of the "Managerial" Enterprise*, 77 Q.J. ECON. 185 (1963).

<sup>15</sup> Romano, *supra* note 12, at 142.

<sup>16</sup> Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 110 (1965).

The basic assumption is that there is an interrelation between share prices and managerial performance.<sup>17</sup> Managerial inefficiency will lead to a decrease in the share price of the mismanaged company.<sup>18</sup> Therefore, a bidder may earn considerable profits if he is able to oust the target's management and run the company in a more efficient way.<sup>19</sup> Accordingly, hostile takeovers are viewed as a cardinal mechanism for ensuring optimal corporate governance and controlling managerial opportunism and slack.<sup>20</sup> On the one hand, a bidder may regenerate firms by toppling their incompetent directors. On the other hand, the threat of a hostile takeover induces the management to increase the share price and act in the shareholders' interests, since a low share price will make the company a target of an alert hostile bidder.<sup>21</sup>

Despite the widespread acceptance of the "market for corporate control theory," there has been strong criticism against it. For instance, the market for corporate control theory assumes that targets of hostile takeovers are inefficiently run companies that the bidder can restructure, thereby generating gains. However, Julian Franks and Colin Mayer found that in the United Kingdom, targets of hostile takeovers are not poor performers in relation to targets of negotiated takeovers or independent companies who are active in the same industry.<sup>22</sup> Furthermore, Blanaid Clarke argues that the application of the market for corporate control theory is limited.<sup>23</sup> First, minor mismanagement is unlikely to have an impact on the company's share price and therefore the "market for corporate control" seems not to apply in relation to hostile takeovers for companies that are not seriously mismanaged. Secondly, a bidder is unlikely to risk acquiring a company that is severely mismanaged, since in most occasions the losses caused by such mismanagement are irreversible. Thus, badly performing firms, where the level of managerial inefficiency is substantial, will not be targets of hostile takeovers. Consequently, the market for corporate control theory should not be treated as a dogma. In addition, even if one accepts their beneficial effects on corporate governance, takeovers do not offer a permanent solution to managerial misbehavior, since they are infrequent and involve heavy costs for the bidder. By the same token, Andrei Shleifer

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<sup>17</sup> *Id.* at 112.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 113.

<sup>20</sup> FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 171 (1996).

<sup>21</sup> Manne, *supra* note 16, at 113.

<sup>22</sup> Julian Franks & Colin Mayer, *Hostile Takeovers and the Correction of Managerial Failure*, 40 J. FIN. ECON. 163, 163 (1996).

<sup>23</sup> Blanaid Clarke, *Articles 9 and 11 of the Takeover Directive (2004/25) and the Market for Corporate Control*, J. BUS. L. 355, 359–60 (2006).

and Robert Vishny observe that takeovers may harm the bidder's shareholders, in the sense that an active "market for corporate control" will allow managers of bidding firms to pursue an empire building tactic through acquisitions.<sup>24</sup> As a result, one should not view hostile takeovers as a silver bullet for the problems arising from the substantive control of the company by managers and the divergence between their interests and the interests of shareholders.

## B. *The Regulation of Takeovers in the United Kingdom*

### 1. *The City Code on Takeovers and Mergers*

The Takeover Code contains the rules that regulate the conduct of takeovers for public companies in the United Kingdom. The prelude of the Code was the Notes on Amalgamations of British Businesses, published in October 1959, which laid down certain principles and the procedure for affecting a takeover. Nonetheless, the Notes "were honoured more in their breach than in their observance."<sup>25</sup> Various takeover battles highlighted the shortcomings of takeover regulation.<sup>26</sup> Furthermore, board resistance to takeovers became frequent. The boards were increasingly deploying defensive measures, which were challenged in courts. In order to scrutinize takeover defenses, the courts applied the "proper purposes doctrine."<sup>27</sup> However, the delay caused by litigation and the uncertain approach of English courts was unacceptable to institutional investors who were favorable towards hostile takeovers.<sup>28</sup> In addition, the fear of government interference with takeover regulation made the need for change even more pressing. As Andrew Johnston notes, "the City's reputation as an investor-friendly environment was coming under threat."<sup>29</sup>

It was against this background that the Takeover Code was introduced on March 27, 1968. Despite constant changes, its main principles, most notably the fair and equal treatment of shareholders, and rules have remained unaltered. The Takeover Code is issued and

<sup>24</sup> Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 756 (1997).

<sup>25</sup> Ross Cranston, *The Rise and Rise of the Hostile Takeover*, in EUROPEAN TAKEOVERS: LAW AND PRACTICE 77 (Klaus J. Hopt & Eddy Wymeersch eds., 1992). QUOTING WILLIAM SHAKESPEARE, HAMLET act 1, sc. 4.

<sup>26</sup> See ALEXANDER JOHNSTON, THE CITY TAKE-OVER CODE 31–37 (1980).

<sup>27</sup> See *Hogg v. Cramphorn Ltd.*, [1967] Ch. 254, 261; *Howard Smith Ltd. v. Ampol Petroleum Ltd.*, [1974] A.C. 821, 827.

<sup>28</sup> Andrew Johnston, *Takeover Regulation: Historical and Theoretical Perspectives on the City Code*, 66 CAMBRIDGE L.J. 422, 436, 442 (2007).

<sup>29</sup> *Id.* at 442.

administered by the Panel on Takeovers and Mergers. Its members are mostly representatives of City institutions. Until the implementation of the Takeover Directive, the Panel's powers did not derive from the statute and the Code did not have the force of law. In the famous words of Sir Donaldson M.R., the Panel "has no statutory, prerogative or common law powers and it is not in contractual relationship with the financial market or with those who deal in that market."<sup>30</sup>

## 2. *The 13th European Takeover Directive and the U.K. Approach*

The importance of the European Takeover Directive was highlighted in the 2000 European Council in Lisbon. The Takeover Directive was seen as an integral part of the effort to enhance the competitiveness of European companies.<sup>31</sup> The history of the Takeover Directive dates back to 1989, when the European Commission put forward the first proposal of a directive concerning takeover bids. This proposal was subsequently abandoned, since it was considered too detailed. A second proposal was made in 1996, this time in the form of a framework directive. After long negotiations and compromises, the directive failed to obtain the necessary majority of the European Parliament. A major point of controversy was the prohibition of post-bid defenses. It was argued that a level playing field did not exist between Member States *inter se* and between the European Union and the United States.<sup>32</sup> While certain Member States would be vulnerable to hostile takeovers, this would not be the case for the United States and other Member States due to structural and legal obstacles.<sup>33</sup> In response to the concerns raised, the High Level of Company Law Experts (Winter Group) was set up in order to make recommendations on certain matters.<sup>34</sup> The two main principles adopted were "shareholder decision-making" and "proportionality between risk-bearing and control."<sup>35</sup> The Takeover Directive was finally enacted in May 2004, though its final version is different from the one envisaged by the Winter Group. In general, the Takeover Directive has been criticized as

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<sup>30</sup> Reg. v. Panel on Take-overs & Mergers, *ex parte Datafin plc*, [1987] Q.B. 815, 825.

<sup>31</sup> Joseph A. McCahery et al., *The Economics of the Proposed European Takeover Directive*, in REFORMING COMPANY LAW AND TAKEOVER LAW IN EUROPE 46 (Guido Ferrarini et al. eds., 2004).

<sup>32</sup> Klaus J. Hopt, *Takeover Regulation in Europe — the Battle for the 13th Directive on Takeovers*, 15 AUSTRALIA J. CORP. L. 1, 9 (2002).

<sup>33</sup> *Id.*

<sup>34</sup> JAAP WINTER ET AL., REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON ISSUES RELATED TO TAKEOVER BIDS (2002).

<sup>35</sup> *Id.* at 20–21.

failing to create a level playing field,<sup>36</sup> mostly due to the optional nature of Articles 9 (prohibition of post-bid defenses) and 11 (breakthrough rule).<sup>37</sup>

The United Kingdom viewed the Takeover Directive as a threat to its self-regulatory system and the advantages of speed, flexibility and certainty, which it conferred.<sup>38</sup> Article 4(1) of the Takeover Directive required the United Kingdom to put the Panel on a statutory footing, which was done by introducing Part 28 in the Companies Act 2006. However, provisions in the Takeover Directive eased the concerns of the U.K. Government. Thus, the system has not changed in its substance. Overall, the implementation of the Takeover Directive had a minimum impact on the Takeover Code. After all, the Takeover Directive was heavily influenced by the U.K. model and its vital provisions, namely the mandatory bid rule and the prohibition of post-bid defenses, have been core elements of the Takeover Code for decades.

### III. COMMON DEFENSIVE MEASURES

A variety of defensive measures have been developed by managers seeking to protect a company from a hostile takeover. The most common distinction is between defenses deployed prior to the bid (pre-bid defenses) and defenses adopted once the bid has been launched (post-bid defenses). One should stress that takeover defenses are viewed negatively by the market and numerous academic studies have concluded that they are associated with lower firm value.<sup>39</sup>

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<sup>36</sup> Frank Wooldridge, *Some Important Provisions, and Implementation of, the Takeovers Directive*, 28 COMPANY LAW. 293, 296 (2007).

<sup>37</sup> See Council Directive 2004/25, arts. 9, 11, 2004 O.J. (L 142) 12, 19–20. However, one should note that the recent assessment report of the Directive commissioned by the European Commission concluded that the Directive had a positive impact in key areas such as disclosure and coordination of cross-border bids making the European legal system more shareholder-oriented; see also CHRISTOPHE CLERC ET AL., THE TAKEOVER BIDS DIRECTIVE ASSESSMENT REPORT 18 (2010).

<sup>38</sup> Criticism of the self-regulatory regime also existed. In particular, the Panel has been criticized for its lenient handling of breaches of the Code by the banks which are also members of it. See G. K. Morse, *The City Code on Takeovers and Mergers—Self Regulation or Self Protection?*, J. BUS. L. 509, 522 (1991).

<sup>39</sup> See Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005); see also Lucian A. Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009) (constructing an entrenchment index consisting of six provisions including the adoption of a staggered board and poison pill and concluding that the entrenching provisions are correlated with lower firm value); Lucian A. Bebchuk et al., *Staggered Boards and*

## A. *Pre-Bid Defenses*

### 1. *Staggered Board*

In the case of a staggered board, the directors of the company are divided into three classes. Only one class (one third of the directors) is elected each year.<sup>40</sup> In essence, directors are granted three-year terms.<sup>41</sup> Consequently, a bidder wishing to obtain control of the board of directors of the company will have to wait two years, even if he holds the majority of the company's shares. One should mention, however, that staggered boards have been justified on the basis that they promote stability in the management of the company and long-term planning, and they strengthen the independence of non-executive from executive directors.<sup>42</sup> A staggered board is ineffective in the United Kingdom, since shareholders may remove directors at any time by a simple majority vote.<sup>43</sup>

### 2. *Poison Pills*

Poison pills or "shareholder rights plans" were devised in the United States<sup>44</sup> by Martin Lipton.<sup>45</sup> In a typical poison pill, the target company will issue rights to shareholders, enabling them to purchase shares of the target company (flip-in scheme) or shares in the acquirer, in case of a merger between the two companies (flip-over scheme), at a substantial discount.<sup>46</sup> The rights are triggered once the bidder's shareholding exceeds a specific threshold. As John Lowry observes, "the most poisonous feature of any pill plan is *dilution*."<sup>47</sup> In a flip-in plan the shareholding of the bidder in the target is effectively diluted. On the contrary, in a flip-over plan it is the shareholders of the bidder who suffer a dilution of their shareholding in the company once a merger occurs. The pill is adopted without shareholder

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*the Wealth of Shareholders: Evidence from Two Natural Experiments* 697 (Harvard Law School, Discussion Paper No. 697, 2011) (finding that staggered boards lead to lower firm value).

<sup>40</sup> Richard H. Koppes, Lyle G. Ganske & Charles T. Haagg, *Corporate Governance out of Focus: The Debate Over Classified Boards*, 54 BUS. LAW. 1023, 1026 (1999).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 1051–54.

<sup>43</sup> Companies Act, 2006 c. 46, § 168.

<sup>44</sup> Their validity was accepted in *Moran v. Household Int'l Inc.*, 500 A.2d 1346 (Del. 1985).

<sup>45</sup> Founding partner of New York law firm Wachtell, Lipton, Rosen & Katz.

<sup>46</sup> John P. Lowry, "Poison Pills" in *U.S. Corporations—A Re-Examination*, J. BUS. L. 337, 340 (1992).

<sup>47</sup> *Id.* at 341.

approval and can be redeemed only by the target's board. Therefore, a bidder will have to launch a proxy fight so as to replace the directors with his own directors who will redeem the pill.<sup>48</sup> However, if a poison pill is combined with a staggered board, then "this safety valve is illusory,"<sup>49</sup> since the acquirer will have to win two annual elections in order to gain control of the board. Lucian Bebchuk, John Coates and Guhan Subramanian argue that the directors should be obliged to redeem the pill after it loses one election.<sup>50</sup>

On the contrary, U.S.-style poison pills are severely regulated in the United Kingdom, where they are mainly adopted in the form of "golden parachutes," break fees and contracts, which put the valuable assets of the company out of the reach of its shareholders.<sup>51</sup> As U.S.-style poison pills involve the issuance of rights, shareholder approval is required.<sup>52</sup> In addition, the adoption of a poison pill will probably be regarded as contravening the duty of directors to act for proper purposes, imposed by section 171 of the Companies Act.<sup>53</sup> Finally, it will likely meet the opposition of shareholders and the media.<sup>54</sup>

### 3. *Non-voting and/or Multiple Voting Shares*

Multiple and non-voting shares allow a shareholder or the directors to consolidate control of the company while holding only a minority stake in it. The validity of weighted voting clauses was upheld in *Bushell v. Faith*, where the court declined to invalidate a provision in the articles that provided, in case of a resolution to remove a director, the directors' shares would carry three votes each.<sup>55</sup> Moreover, in *Rights & Issues Investment Trust Ltd. v. Stylo Shoes Ltd.*<sup>56</sup> the voting power of the management shares was increased by resolutions of the general meeting of shareholders and the class meeting of ordinary shareholders.<sup>57</sup> The court considered that there

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<sup>48</sup> David Kershaw, *The Illusion of Importance: Reconsidering the U.K.'s Takeover Defence Prohibition*, 56 I.C.L.Q. 267, 290 (2007).

<sup>49</sup> Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 890 (2002).

<sup>50</sup> *Id.* at 944–45.

<sup>51</sup> Blanaid Clarke, *Regulating Poison Pill Devices*, 4 J. CORP. L. STUD. 51, 52 (2004).

<sup>52</sup> Companies Act 2006, c. 46, § 551.

<sup>53</sup> *Id.* at § 171.

<sup>54</sup> BUTTERWORTHS TAKEOVERS: LAW AND PRACTICE 419 (Gary Eaborn ed., 2d ed. 2005).

<sup>55</sup> [1970] A.C. 1099 (H.L.) (appeal taken from Eng.).

<sup>56</sup> [1965] Ch. 250.

<sup>57</sup> *Id.* at 251.

was no discrimination against ordinary shareholders.<sup>58</sup> It should be stressed that the court particularly took into account the fact that the holders of the management shares did not vote on either resolution.<sup>59</sup> Thus, “[t]heir self-denying act was . . . a very effective piece of window-dressing.”<sup>60</sup>

As far as non-voting shares are concerned, they are perfectly legitimate under English law. Though, companies have been reluctant to introduce non-voting shares into their capital structure due to the strong resistance of institutional investors.<sup>61</sup> The rationale behind the acceptance of non-voting shares can be found in the report of the Jenkins Committee.<sup>62</sup> A total interdiction of non-voting shares is viewed as “an unwarranted interference with freedom of contract.”<sup>63</sup> Accordingly, the company and its investors should be allowed to carry out their bargain.

## B. *Post-Bid Defenses*

### 1. *Litigation*

Litigation is a common feature of U.S. takeover battles. John Armour and David Skeel present data showing that between 1990 and 2005, 33.9% of all hostile offers were litigated.<sup>64</sup> Apart from this being a costly way of dispute resolution, litigation may potentially serve as a takeover defense. It can either delay the takeover process, giving the board sufficient time to deploy other defensive tactics, or it can alone frustrate the bid.<sup>65</sup> Therefore, litigation may inhibit the beneficial function of the market for corporate control.<sup>66</sup>

In the United Kingdom, proceedings initiated with the purpose of frustrating or hampering a takeover are characterized as “tactical

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<sup>58</sup> *Id.* at 254.

<sup>59</sup> *Id.*

<sup>60</sup> LEN SEALY & SARAH WORTHINGTON, *CASES AND MATERIALS IN COMPANY LAW* 218 (8th ed. 2008).

<sup>61</sup> MARK AUBREY WEINBERG ET AL., *WEINBERG AND BLANK ON TAKEOVERS AND MERGERS* 597 (4th ed. 1979).

<sup>62</sup> BOARD OF TRADE, *REPORT OF THE COMPANY LAW COMMITTEE, 1962*, Cmnd. 1749, at para. 126 (U.K.).

<sup>63</sup> *Id.* at para. 128.

<sup>64</sup> John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 *GEO. L.J.* 1727, 1748 (2007).

<sup>65</sup> Kershaw, *supra* note 48, at 279.

<sup>66</sup> Tunde I. Ogowewo, *Tactical Litigation in Takeover Contests*, *J. BUS. L.* 589, 612 (2007).

litigation.”<sup>67</sup> Nevertheless, the scope for litigation is minimal. Proceedings brought by the target’s management will probably be considered as “frustrating action” under Rule 21.1 of the Takeover Code.<sup>68</sup> What is more, it is an established principle that the courts will not scrutinize the decisions of the Panel during the takeover offer, but their intervention will only be at a later stage by means of declaratory orders guiding the Panel as to its future conduct.<sup>69</sup> Additionally, “contravention of a rule-based requirement or a disclosure requirement does not give rise to any right of action for breach of statutory duty.”<sup>70</sup> Lastly, by virtue of section 961 of the Companies Act 2006, the Panel is exempted from liability arising from the performance of its functions, unless it has acted in bad faith.<sup>71</sup>

## 2. *White Squire*

A white squire defense involves the issuance of shares to a third party who will support the target in its efforts to remain independent. The white squire will be a person or a company friendly to the target’s board and will usually purchase shares which will give him a twenty-five percent to thirty percent stake in the target’s share capital.<sup>72</sup> The effect of this defense is to increase the number of shares outstanding, making it necessary for the hostile bidder to buy more shares and thereby increasing the cost of the takeover.<sup>73</sup> Furthermore, the bidder will not be able to purchase the shareholding of the white squire.<sup>74</sup> If it is large enough, for instance twenty-five percent, he will be unable to obtain effective control.<sup>75</sup>

## IV. REGULATION OF PRE-BID DEFENSES

### A. *Directors’ Fiduciary Duties*

Rule 21 of the Takeover Code only prohibits post-bid defenses.

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<sup>67</sup> DEP’T OF TRADE & INDUS., COMPANY LAW IMPLEMENTATION OF THE EUROPEAN DIRECTIVE ON TAKEOVER BIDS – A CONSULTATIVE DOCUMENT, 2005, at para. 2.32.

<sup>68</sup> THE TAKEOVER CODE, *supra* note 7, at Rule 21.1.

<sup>69</sup> Reg. v. Panel on Take-overs & Mergers, *ex parte Datafin plc*, [1987] Q.B. 815, 842.

<sup>70</sup> Companies Act 2006, c. 46, § 956(1).

<sup>71</sup> *See id.* § 961.

<sup>72</sup> William Underhill & Andreas Austmann, *Defence Tactics*, in TAKEOVERS IN ENGLISH AND GERMAN LAW 87, 112 (Jennifer Payne ed., 2002).

<sup>73</sup> STEPHEN KENYON-SLADE, MERGERS AND TAKEOVERS IN THE US AND UK 379 (2004).

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

Pre-bid defenses are regulated by the fiduciary duties that a director owes to the company. The same rules are also applicable to defenses adopted during the takeover. However, their impact is minimized by Rule 21 of the Takeover Code.<sup>76</sup> Particularly important in the takeover context are the duties to act within powers and to promote the success of the company. Nonetheless, regulation of defensive measures under directors' fiduciary duties remains incomplete. After the introduction of the Takeover Code and the total ban on defensive measures, the law in this area has remained static.<sup>77</sup> Since no cases were brought before them, the courts were not able to develop a comprehensive approach towards takeover defenses.<sup>78</sup>

In addition, directors' duties are owed to the company and not to the shareholders.<sup>79</sup> Therefore, a shareholder wishing to initiate litigation for breach of duty will have to bring a derivative claim and go through the cumbersome procedure laid down in sections 261 through 263 of the Companies Act 2006.<sup>80</sup> Only in rare circumstances do directors owe fiduciary duties directly to the shareholders. In *Peskin v. Anderson*,<sup>81</sup> Lord Justice Mummery accepted that directors may owe fiduciary obligations to the shareholders. He pointed that fiduciary duties owed to the shareholders "are dependent on establishing a special factual relationship between the directors and the shareholders in the particular case."<sup>82</sup>

### 1. *Duty to Promote the Success of the Company*

Section 172 of the Companies Act 2006 requires a director to "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."<sup>83</sup> Further, section 172 contains a list of factors that a director should take into account.<sup>84</sup> Despite the adoption of an "enlightened shareholder value" approach, it is clear that "the rule of shareholder primacy is reiterated in the section."<sup>85</sup> The abovementioned section imposes a highly substantive duty. As stated in *In re Smith & Fawcett, Ltd.*, directors "must exercise their discretion bona fide in what they consider—not what a court may consider—is in the interests of the company, and not for any collateral

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<sup>76</sup> See GOWER AND DAVIES: THE PRINCIPLES OF MODERN COMPANY LAW (Paul L. Davies ed., 8th ed. 2007) [hereinafter GOWER AND DAVIES].

<sup>77</sup> KENYON-SLADE, *supra* note 73, at 729.

<sup>78</sup> Johnston, *supra* note 28, at 441.

<sup>79</sup> Percival v. Wright [1902] 2 Ch. 421.

<sup>80</sup> Companies Act 2006, c. 46, §§ 261–63.

<sup>81</sup> [2000] BCC 874.

<sup>82</sup> *Id.* at 880.

<sup>83</sup> Companies Act 2006, c. 46, § 172.

<sup>84</sup> *Id.*

<sup>85</sup> GOWER AND DAVIES, *supra* note 76, at 508.

purpose.”<sup>86</sup> Directors are afforded the protection of the business judgment rule, which reflects the unwillingness of the courts to interfere with business decisions reached by the directors in good faith. Thus, the highly substantive nature of this duty does not allow courts to effectively monitor directors’ defensive actions. In fact, directors commonly justify their actions in fending off a hostile bidder seeking to remove management on the grounds that the offer undervalues the long-term value of the company.

## 2. *Duty to Act Within Powers*

The most important limitation on directors’ frustrating action is the proper purposes doctrine. According to section 171,<sup>87</sup> a director must exercise his powers for the purposes for which they are granted. *Hogg v. Cramphorn Ltd.* remains the maverick case.<sup>88</sup> The directors of Cramphorn sought to frustrate a takeover bid that they believed would be devastating for the company.<sup>89</sup> The board issued shares carrying ten votes per share to a trust created for the benefit of the employees.<sup>90</sup> The court held that the directors had improperly used their power to allot shares.<sup>91</sup> This was so, even though the court found that the allotment of shares was not tainted by self-interest and that the directors had acted in good faith.<sup>92</sup> The fundamental purpose of the scheme was to ensure that the board would remain in control of the company.<sup>93</sup> However, it was accepted that a general meeting of shareholders could ratify the improper allotment of shares.<sup>94</sup>

A similar case involving a defensive issuance of shares is *Howard Smith Ltd. v. Ampol Petroleum Ltd.*<sup>95</sup> The company, Miller, was faced with two competing bids by Howard and Ampol.<sup>96</sup> The directors issued shares to Howard with the purpose of diluting the majority shareholding of Ampol and another company, named Bulkships, and enabling Howard to proceed with its offer.<sup>97</sup> The court concluded that the allotment of shares was an improper use of the directors’ powers.<sup>98</sup> The sole purpose of the allotment

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<sup>86</sup> [1942] Ch. 304, 306.

<sup>87</sup> Companies Act 2006, c. 46, § 171.

<sup>88</sup> [1967] Ch. 254.

<sup>89</sup> *Id.* at 255.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.* at 271.

<sup>92</sup> *Id.* at 255.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* at 271; *see also* Bamford v. Bamford, [1970] Ch. 212.

<sup>95</sup> [1974] A.C. 821.

<sup>96</sup> *Id.* at 823.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* at 838.

was to dilute the voting power of the majority shareholders.<sup>99</sup> Directors should not use their powers “purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist.”<sup>100</sup>

Accordingly, directors’ actions whose primary purpose is to fend off a takeover bid will lead to a breach of duty. It is crucial to underline that section 171 is less effective than the total ban on defensive tactics imposed by the Takeover Code. In particular, the proper purposes doctrine focuses on the primary purpose of the directors’ acts and not on their effect. Therefore, acts which have the effect of making a company bid proof will be valid if the directors can advance a commercial justification as their prevalent purpose.<sup>101</sup> In this case, given the traditional non-interventionist stance of the English courts, it will be difficult for a challenger to establish that the predominant purpose of the management’s acts was to protect the company against a takeover.<sup>102</sup>

Nevertheless, section 171 effectively regulates U.S.-style poison pills. Poison pills were devised in the United States in order to shelter shareholders from coercive two-tier<sup>103</sup> and partial tender offers. Various commentators have accepted that shareholders faced with a coercive two-tier tender offer or partial offer may be pressurized to tender even though they consider that the offer price is inadequate.<sup>104</sup> In a partial offer, a shareholder will tender his shares fearing that he will end up with low-value minority shares. The same problem exists in two-tier tender offers where the shareholder who has not tendered his shares at the first offer will be left with the back-end lower price. Hence, an acquirer may secure control of the target “even if the target’s shareholders view rejection of the bid as their value-maximizing course of action.”<sup>105</sup>

On the other hand, a similar problem does not exist in the United Kingdom. Partial and two-tier offers are hindered by the mandatory bid rule, which requires any person who acquires thirty percent or more of the

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<sup>99</sup> *Id.* at 837.

<sup>100</sup> *Id.*

<sup>101</sup> GOWER AND DAVIES, *supra* note 76, at 988.

<sup>102</sup> Paul L. Davies, *Defensive Measure: The Anglo-American Approach*, in EUROPEAN TAKEOVERS: LAW AND PRACTICE (Klaus J. Hopt & Eddy Wymeersch eds., 1992).

<sup>103</sup> In a front-end loaded two-tier tender offer, the bidder launches a first partial bid at a high price stating his intention to effect a back-end merger at a lower price. See KENYON-SLADE, *supra* note 73, at 54.

<sup>104</sup> See Lucian A. Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911 (1987).

<sup>105</sup> *Id.* at 928. However, Bebchuk argues that the pressure to tender exists in all bids, even in all-share ones; see *id.* at 927.

voting rights of the company to launch a bid for the whole share capital of the target,<sup>106</sup> at the highest price paid by the offeror for shares obtained during the twelve months prior to the takeover.<sup>107</sup> For instance, an acquirer who has launched a partial offer and has obtained thirty percent or more of the share capital will have to make an offer for all the shares at the price of the first partial offer. In light of the above, one could argue that a poison pill serves no purpose other than to thwart a hostile takeover. Resultantly, the adoption of a poison pill by the board of a U.K. company is not allowed, unless shareholder ratification is obtained.

## B. *The Breakthrough Rule*

### 1. *The Mini-Breakthrough Rule*

The High Level Group of Company Law Experts, concerned with some widely used pre-bid defenses which consolidate control in the hands of the directors or shareholders,<sup>108</sup> recognized that any takeover legislation should be founded on the principle of “proportionality between risk bearing and control.”<sup>109</sup> The Winter Group considered that “the extent to which a shareholder holds risk bearing capital should determine the extent to which he is able to determine the affairs of the company and the operation of its business. The holder of the majority of risk bearing capital should be able to exercise control.”<sup>110</sup> Therefore, disproportionate corporate structures should not inhibit a bidder from obtaining control. The Winter Group took the view that the proportionality principle should be applicable only in the takeover arena. A general application of the principle would be too drastic a step. There are many compelling reasons why such a general application is not beneficial. A one-share, one-vote principle would prevent daring innovations in capital structures and bar blockholders, who wish to take their firm public whilst maintaining control, from accessing the capital markets, thereby violating their freedom of choice.<sup>111</sup>

Thus, the Winter Group favored the adoption of the breakthrough rule, which would be applicable only in the context of a takeover bid. The final version of the rule,<sup>112</sup> though, has been characterized as a “mini-

<sup>106</sup> THE TAKEOVER CODE, *supra* note 7, at Rule 9.1.

<sup>107</sup> *Id.* at Rule 9.5.

<sup>108</sup> These include: multiple voting rights, voting caps and cross shareholdings. These structures are commonly used in the European Union.

<sup>109</sup> WINTER ET AL., *supra* note 34, at 20.

<sup>110</sup> *Id.* at 21.

<sup>111</sup> Jonathan Rickford, *The Emerging European Takeover Law from a British Perspective*, 15 EUR. BUS. L. REV. 1379, 1385 (2004).

<sup>112</sup> Directive 2004/25, art. 11, 2004 O.J. (L 142) 12, 20 (EC).

breakthrough rule,” because it does not regulate all the restrictions in the articles or otherwise which violate the proportionality principle.<sup>113</sup> In addition, its optional implementation by the Member States waters down any beneficial effects deriving from the rule.<sup>114</sup>

Article 11(2) of the Takeover Directive provides that any restriction on the transfer of securities imposed by the articles of association or by contract will not apply vis-à-vis the bidder during the offer period.<sup>115</sup> Moreover, by virtue of Article 11(3), any restrictions on voting rights imposed either by the articles or by contractual agreements shall not apply at the general meeting which decides on the authorization of takeover defenses.<sup>116</sup> Furthermore, multiple voting shares will carry one vote per share at this meeting. Similarly, Article 11(4) states that once the bidder acquires seventy-five percent or more of the capital carrying voting rights, restrictions on the transfer of securities or on voting rights contained in the articles or in certain contracts and special rights entitling certain shareholders to appoint or remove board members shall be ineffective.<sup>117</sup> In addition, multiple voting shares “shall carry only one vote each at the first general meeting of shareholders following closure of the bid, called by the offeror in order to amend the articles of association or to remove or appoint board members.”<sup>118</sup> Lastly, Article 12(1) allows Member States to opt out of Article 11.<sup>119</sup>

The breakthrough rule has been criticized both for its substance and for its optional nature.<sup>120</sup> At a substantive level, the rule leaves intact several potent pre-bid defenses. Cross shareholdings and pyramid structures are not covered by the rule.<sup>121</sup> Indeed, as Oliver Hart and Lucian Bebchuk argue, the rule will not prevent “the separation of voting rights and cash-flow rights in companies that go public in the future.”<sup>122</sup> Companies will

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<sup>113</sup> Rickford, *supra* note 111, at 1389.

<sup>114</sup> Ferna Ipekeli, *Defensive Measures Under the Directive on Takeover Bids and Their Effect on the UK and French Takeover Regimes*, 16 EUR. BUS. L. REV. 341, 345 (2005).

<sup>115</sup> Directive 2004/25, art. 11(2), 2004 O.J. (L 142) 12, 20 (EC).

<sup>116</sup> *Id.* art. 11(3), at 20.

<sup>117</sup> *Id.* art. 11(4), at 20.

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* art. 12(1), at 21.

<sup>120</sup> Rickford, *supra* note 111, at 1390.

<sup>121</sup> Thomas Papadopoulos, *Legal Aspects of the Breakthrough Rule of the European Takeover Bid Directive* 10–13 (2008) (unpublished paper), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1114671](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1114671).

<sup>122</sup> Lucian Bebchuk & Oliver Hart, *A Threat to Dual-Class Shares*, FIN. TIMES, May 31, 2002.

simply evade the rule by using pyramid structures.<sup>123</sup> What is more, the breakthrough rule does not apply to shares with limited voting rights, a common disproportionate capital structure. The characteristic of a limited voting share, namely the fact that it does not carry any votes, is unlikely to be regarded as a restriction on voting for the purposes of Article 11(3).<sup>124</sup> There are even doubts relating to the necessity of the rule. As Clarke notes, blockholder control in Europe is rarely a result of disproportionate capital structures and in most cases blockholders secure control by holding the majority of shares in a single-share capital structure.<sup>125</sup> As far as the optional nature of the rule is concerned, it is clear that the Directive does not succeed in creating a level playing field.<sup>126</sup>

## 2. *The U.K. Approach*

The United Kingdom decided to opt out of the breakthrough rule. It was considered that the problem of disproportionate structures was not so pressing. Due to pressure from institutional investors, only a minority of listed companies continue to use multiple or non-voting shares or restrictions on voting rights.<sup>127</sup> In addition, it was accepted that in certain circumstances disproportionate structures may be beneficial for a company.<sup>128</sup> Nonetheless, according to Article 12(2) of the Takeover Directive, the United Kingdom was obliged to grant companies incorporated in the United Kingdom the right to opt back into Article 11. As a result, Chapter 2 of Part 28 of the Companies Act 2006 provides the procedure for opting back into the breakthrough rule.

Section 966 of the Companies Act states that a company may opt back into the breakthrough rule by a special resolution, but only if its “voting shares are admitted to trading on a regulated market.”<sup>129</sup> Hence, the opt in is only granted to companies that fall within the ambit of the Directive. Moreover, two other conditions have to be met. By virtue of section 966(4) of the Act, the company may not opt back into the breakthrough rule if a minister, or a company under his control, holds shares carrying special rights. Furthermore, its articles must not contradict Article 11 of the Directive.<sup>130</sup>

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<sup>123</sup> *Id.*

<sup>124</sup> Rickford, *supra* note 111, at 1391.

<sup>125</sup> Clarke, *supra* note 23, at 368.

<sup>126</sup> Ipekeli, *supra* note 114, at 345.

<sup>127</sup> DEP'T OF TRADE & INDUS., *supra* note 67, para. 3.7.

<sup>128</sup> *Id.* para. 3.9.

<sup>129</sup> Companies Act 2006, c. 46, § 966(2).

<sup>130</sup> *Id.* § 966(3).

V. POST-BID DEFENSES AND THE PRINCIPLE OF  
“SHAREHOLDER CHOICE”A. *The Regulation of Post-Bid Defenses*

The term post-bid defenses refers to all takeover defenses taken by the board once a bid has been made. These are regulated by Rule 21 of the Takeover Code, which requires the management to abstain from deploying post-bid defenses without shareholder approval.<sup>131</sup> Therefore, the Takeover Code adopts the principle of “shareholder choice” and consolidates an active “market for corporate control” by restricting management’s actions when faced with a hostile takeover offer. Indeed, the prohibition of post-bid defenses has been a central rule of the U.K. Takeover Code since its first version, affirming its shareholder-oriented approach. John Armour and David Skeel view this approach as a result of the involvement of institutional investors in the drafting of the Code in 1968, which by that time had already emerged as a significant power in the British corporate landscape.<sup>132</sup> In addition, the retention of the neutrality rule, in spite of the continuous revisions and amendments to the Code, is attributed to the wide composition of the Takeover Panel by various market participants, which ensures that corporate managers do not have an undue influence in the rule-making process.<sup>133</sup>

Rule 21.1 states that once an offer has been made or “if the board of the offeree company has reason to believe that a ‘bona fide offer’ might be imminent, the board must not take any frustrating action without shareholder approval.”<sup>134</sup> The Rule imposes a total ban on defensive actions, unless shareholders decide otherwise. Unlike the proper purposes doctrine, Rule 21 restricts all actions which have the effect of frustrating a takeover offer. The purpose of the directors is irrelevant. The rule applies not only after the launch of a bid, but also from the time “the board has reason to believe that a ‘bona fide’ offer might be imminent.”<sup>135</sup> Regarding the meaning of the term “bona fide,” it is not concerned with the motives of the bidding firm, but with the credibility of the potential offer and the adequacy of its financing.<sup>136</sup> What is more, Rule 21 lists certain defensive measures which the board cannot take, such as the issue of shares (white squire). However, the list is not exhaustive. The Takeover Code forbids any

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<sup>131</sup> THE TAKEOVER CODE, *supra* note 7, at R. 21.

<sup>132</sup> Armour & Skeel, *supra* note 64, at 1771.

<sup>133</sup> Allen Ferrell, *Why Continental European Takeover Law Matters, in REFORMING COMPANY AND TAKEOVER LAW IN EUROPE* 571 (Guido Ferrarini et al. eds., 2004).

<sup>134</sup> THE TAKEOVER CODE, *supra* note 7, at R. 21.1

<sup>135</sup> THE TAKEOVER CODE, *supra* note 7, at R. 21.1.

<sup>136</sup> Ogowewo, *supra* note 66, at 598–99.

action whose effect is to thwart a bid, irrespective of its form. This allows the Panel to maintain flexibility in its approach and to confront directors' creativity in inventing new mechanisms. For instance, the panel in *Consolidated Gold Fields PLC* considered that litigation initiated by the target's board resulting in the frustration of a bid falls within the ambit of the no-frustration rule, despite not being expressly stated.<sup>137</sup> The issue concerned antitrust litigation brought before U.S. courts by the wholly-owned subsidiary of Consolidated Gold Fields, which was the target of a takeover offer by Minorco.<sup>138</sup> The Panel took the view that the proceedings initiated in the United States constituted a breach of General Principle 7 (now Rule 21 of the Takeover Code) and the board should abandon them, unless shareholder approval was obtained.<sup>139</sup>

Consequently, the defenses available to the target's management are limited to persuading their shareholders that they should not tender their shares, lobbying the competition authorities and inducing a white knight to enter the takeover battle.<sup>140</sup>

### 1. *White Knights*

As mentioned above, the board of the target company may seek a competing bidder (white knight) without shareholder approval. The search for a white knight is considered to be beneficial as it increases shareholders' wealth.<sup>141</sup> In essence, shares are put in an auction<sup>142</sup> allowing shareholders to obtain the best possible price. In fact, Rule 31.1 of the Takeover Code, which provides that the offer should be open for a minimum of twenty-one days, fosters competing bids, since directors have adequate time to search for a white knight. Thereupon, one could argue that the Takeover Code adopts a positive stance towards competing bids. At the same time, however, it seeks to secure the equal treatment of competing bidders. Rule 20.2 requires the board of the target to provide to a less welcome offeror all the information supplied to any other bidder.

Despite the clear preference of the Takeover Code towards competing bids, Davies and Hopt observe that promoting the appearance of

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<sup>137</sup> See generally CONSOLIDATED GOLD FIELDS PLC, THE TAKEOVER PANEL STATEMENT 1989/7.

<sup>138</sup> *Id.* at 1.

<sup>139</sup> *Id.* at 2.

<sup>140</sup> GOWER AND DAVIES, *supra* note 76, at 986.

<sup>141</sup> Federico M. Mucciarelli, *White Knights and Black Knights: Does the Search for Competitive Bids Always Benefit the Shareholders of "Target" Companies?* 8 (June 15, 2006) (working paper).

<sup>142</sup> *Id.*

white knights may result in making bidders less willing to launch bids.<sup>143</sup> Bidders bear considerable costs in selecting the target company and obtaining information about it (search costs).<sup>144</sup> Fostering competing bids allows subsequent bidders to free-ride on the efforts of the first offeror, whose search costs will be unrecoverable if a second bidder wins the auction.<sup>145</sup> As a result, the total number of takeovers will decrease, because bidders will be reluctant to commence an offer without any reassurance that the effort and money they spend will not be wasted.<sup>146</sup>

Transactional lawyers have devised a variety of protections for the first bidder, the most common of which are break fees and securing the agreement of the target's management not to encourage or solicit white knights.

In the case of break fees, the target company will enter into an agreement with the first bidder, which will provide for the payment of a fixed amount if his offer is unsuccessful due to the appearance of a competing bid. The particular terms of the contract will be agreed upon after negotiations between the parties. For example, the agreement may provide that even the mere appearance of a competing bid will be sufficient to trigger the payment of break fees. Break fees are expressly prohibited by the Takeover Code.<sup>147</sup> Following the amendments to the Takeover Code adopted in response to public outrage sparked by Kraft's hostile acquisition of Cadbury, Rule 21.2 bans any deal protection devices including break fees.<sup>148</sup> Break fees are only allowed in the case of a board-initiated formal sale process and in order to solicit a white knight in response to a hostile takeover offer. In the latter case, the break fee may not exceed one percent of the target's value, calculated by reference to the price offered by the white knight. Furthermore, contracts not to solicit or encourage white knights are caught by the general ban on deal protection devices. The general ban of deal protection devices is expected to significantly chill takeover activity in the United Kingdom by making bidders less willing to commence takeover offers without being able to secure the reimbursement of their expenses.<sup>149</sup> What is more, the general prohibition of deal

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<sup>143</sup> Paul Davies & Klaus Hopt, *Control Transactions*, in *THE ANATOMY OF CORPORATE LAW, A COMPARATIVE AND FUNCTIONAL APPROACH* 182 (2004).

<sup>144</sup> EASTERBROOK & FISCHER, *supra* note 20, at 187–88.

<sup>145</sup> *Id.*

<sup>146</sup> Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1179 (1981).

<sup>147</sup> THE TAKEOVER CODE, *supra* note 7, at Rule 21.2.

<sup>148</sup> THE TAKEOVER CODE, *supra* note 7, at Rule 21.2.

<sup>149</sup> Leon Ferera & Simon Kiff, Jones Day, *The Takeover Panel's Review of Certain Aspects of the Regulation of Takeover Bids in the UK*, BLOOMBERG LAW,

protection devices may have the adverse effect of deterring friendly acquisitions and promoting hostile ones instead.<sup>150</sup>

### B. *The Principle of Shareholder Choice*

As one can easily discern, the U.K. regime has adopted a strong pro-shareholder approach by totally banning takeover defenses, unless authorized by the shareholders at the general shareholder meeting.<sup>151</sup> Thus, the decision on whether the bid should succeed is transferred from the board to the shareholders. Inherent in this “shareholder choice” approach is the premise that directors will use their power to block an offer in order to further their own interests. It is in the takeover context that the conflict between the directors’ and the shareholders’ interests takes one of its most severe forms.<sup>152</sup> If the takeover succeeds, directors might lose their jobs and all the benefits associated with the control of the corporation. Consequently, their interest is in preserving their jobs and reputation, instead of enhancing shareholder value.<sup>153</sup> Furthermore, a board veto will have a negative impact on the firm’s performance even before the launch of a takeover bid. In particular, Bebchuk correctly observes that it will severely curtail the

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<http://about.bloomberglaw.com/practitioner-contributions/the-takeover-panels/> (last visited Oct. 21, 2013); see Thanos Panagopoulos, *Thinking Inside the Box: Analyzing Judicial Scrutiny of Deal Protection Devices in Delaware*, 3 BERKELEY BUS. L.J. 437 (2006); Albert O. “Chip” Saulsbury, IV, *The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies*, 37 DEL. J. CORP. L. 115, 151–54 (2012); see also John C. Coates IV, *M&A Break Fees: US Litigation versus UK Regulation* (Harvard Pub. Law, Working Paper No. 09-57, 2009) (suggesting that the more lenient approach to deal protection in the United States results in a higher level of bid incidences relative to the United Kingdom), available at <http://ssrn.com/abstracts=1475354>. Delaware’s courts evaluate deal protection devices as defensive mechanisms under the *Unocal* test. See generally *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

<sup>150</sup> Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 162–63 (2012) (noting that the recent amendments to the Takeover Code, including the ban on deal protection devices, will make the negotiation and conclusion of friendly acquisitions, rather than hostile ones, considerably more difficult for targets).

<sup>151</sup> Proponents of shareholder primacy in corporate takeovers embrace the property conception of the corporation. Pursuant to the property conception, the sole purpose of the corporation is the maximization of shareholder value; see William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1075 (2002).

<sup>152</sup> George O. Barboutis, *Takeover Defence Tactics: Part I: The General Legal Framework on Takeovers*, 20 COMPANY LAW. 14 (1999).

<sup>153</sup> WINTER ET AL., *supra* note 34, at 21.

disciplinary function of the hostile takeover.<sup>154</sup> Directors, knowing that they are not vulnerable to a hostile takeover, will not have any incentive to enhance their performance and act in the shareholders' interests.<sup>155</sup>

Frank Easterbrook and Daniel Fischel suggest that takeovers are beneficial to both shareholders and society, and any mechanism designed to prevent takeovers reduces welfare.<sup>156</sup> Adhering to the "efficient capital markets hypothesis," they conclude that a bid at a premium over the market price of the shares always benefits shareholders, because in an efficient market shares are never undervalued and accurately reflect the true value of the firm.<sup>157</sup> Therefore, the possibility of a bidder making gains by offering a premium over the market price, but below the true value of the firm, is excluded. Hence, shareholders always win and management should never be able to hamper a bid. Even resistance that leads to a higher premium is unacceptable. Higher premiums will depress the bidders' gains and, as a result, the bidders will be more reluctant to commence takeovers.<sup>158</sup>

## VI. TRANSPLANTING THE U.S. REGIME

As illustrated below, the United States adopts a diametrically opposite approach towards hostile takeovers by permitting directors to resort to a variety of defensive measures. This divergence seems peculiar, considering the common characteristics which these two countries share, namely dispersed ownership of public corporations and a risk-taking entrepreneurial culture which supports takeovers as control shifting transactions.<sup>159</sup> Moreover, academics and regulators in both countries view hostile takeovers as an essential device for ensuring efficient corporate governance. The most common explanation of this managerialistic stance of the U.S. regime is the "race to the bottom theory."<sup>160</sup> Because managers have authority over reincorporation decisions, a state, in order to attract

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<sup>154</sup> Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 994 (2002).

<sup>155</sup> *Id.* at 993.

<sup>156</sup> Easterbrook & Fischel, *supra* note 122, at 1174.

<sup>157</sup> *Id.* at 1165–68.

<sup>158</sup> EASTERBROOK & FISCHEL, *supra* note 20, at 173.

<sup>159</sup> GOWER AND DAVIES, *supra* note 76, at 198.

<sup>160</sup> William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). Cary was the first to articulate this proposition. He claimed that the thirst of Delaware for revenues generated by incorporations has led it to develop a lax corporate regime. In turn, this has influenced other states, which compete with each other in a race to the bottom. *But see* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209 (2006) (arguing that competition allows for the proliferation of innovative and efficient state corporate law rules).

more companies through reincorporations from other states, or alternatively prevent a flight of companies to other states, will adopt a lenient stance towards management takeover rules.<sup>161</sup> Therefore, states have incentives to provide rules that shield the management from hostile takeovers.

*A. The Regulation of Takeovers and Defensive Mechanisms  
in the United States.*

*1. Federal and State Law*

At a federal level, takeovers are regulated by the Williams Act of 1968, which amended the Securities and Exchange Act of 1934. The Williams Act sets certain minimum procedural safeguards and seeks to ensure the equal treatment of the target's shareholders. Compliance with the rules imposed by the Williams Act is overseen by the SEC.

Section 13(d) of the Securities and Exchange Act 1934 provides that any person who acquires "beneficial ownership" of five percent or more of a company's shares must disclose his acquisition to the company which issued the shares, to the SEC and to any exchange where the shares of the company are traded.<sup>162</sup> As a result, the Williams Act prevents the secret accumulation of controlling shareholdings.

As far as the procedural requirements are concerned, the most important of them is the obligation of the bidder to keep the tender offer open for at least twenty days.<sup>163</sup> By providing a minimum offer period, the Act eliminates the possibility of "Saturday Night Specials," namely offers that were open for a short period of time, thereby putting tremendous pressure on shareholders to tender. In addition, if a partial bid is made and the tendered shares are more than the amount requested by the bidder, then the bidder shall purchase all the shares tendered on a "pro-rata basis" according to the number of securities tendered by each shareholder during the twenty-day period.<sup>164</sup> Thus, shareholders are protected against tender offers "on a first come, first served basis." Lastly, the bidder is obliged to purchase the tendered shares for the highest price paid during the offer period.<sup>165</sup>

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<sup>161</sup> Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1173–74 (1999).

<sup>162</sup> See Exchange Act Rule, 17 C.F.R. § 240.13d-1(a)(i) (2012).

<sup>163</sup> *Id.* § 240.14e-1.

<sup>164</sup> *Id.* § 240.14d-8.

<sup>165</sup> *Id.* § 240.14d-10(a)(2).

In this way, the equal treatment of all shareholders is ensured, since they are all entitled to receive the same consideration. Since the Williams Act regulates limited aspects of takeovers, states, exercising their traditional authority over corporate law matters, have enacted a variety of takeover statutes or more correctly “anti-takeover statutes.” The first generation of these statutes was short-lived. Their constitutionality was considered in *Edgar v. MITE Corp.*, where the Illinois Business Takeover Act was struck down as unconstitutional for indirectly inhibiting inter-state commerce.<sup>166</sup> Based upon that reasoning, the courts invalidated a number of other statutes, leading states to the adoption of second generation anti-takeover statutes. Their validity was accepted in *CTS Corp. v. Dynamics Corp. of America*.<sup>167</sup> Second generation statutes impose even stricter conditions and essentially operate as defenses against hostile takeovers. Examples are “control share cash-out statutes.” These statutes grant shareholders the right to demand the bidder purchase their shares at a fair value once he exceeds a certain threshold.<sup>168</sup> The states went even further and excogitated a third generation of anti-takeover statutes. “Business combination statutes” prevent a bidder from engaging in certain transactions, such as mergers, after the takeover succeeds, unless the consent of the board of directors or an enhanced shareholder majority is obtained.<sup>169</sup> Although certain statutes, for instance control share cash-out statutes, are justifiable on the basis of shareholder protection, Bebchuk observes that other state statutes, most notably business combination statutes, were primarily designed to impede takeovers, rather than shield shareholders’ interests.<sup>170</sup>

## 2. *The Judicial Regulation of Takeover Defenses*

It is clear that U.S. federal or state takeover law does not contain any rule regulating the use of defensive tactics created by managers. In contrast, state law arms them with new ones. As a result, their regulation is left to the courts,<sup>171</sup> which have the authority to decide the legitimacy of

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<sup>166</sup> 457 U.S. 624, 630–31 (1982).

<sup>167</sup> 481 U.S. 69, 77–78 (1987).

<sup>168</sup> EDWIN L. MILLER JR., *MERGERS AND ACQUISITIONS: A STEP-BY-STEP LEGAL AND PRACTICAL GUIDE* 280–82 (2008).

<sup>169</sup> KENYON-SLADE, *supra* note 73, at 193–94.

<sup>170</sup> Bebchuk & Ferrell, *supra* note 161, at 1182–83.

<sup>171</sup> See generally Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1913–19 (1998). The discussion below will be limited to judicial developments in the state of Delaware, the preferred state of incorporation for the overwhelming majority of U.S. companies. Delaware’s competitive advantages include a highly specialized judiciary in resolving corporate law disputes and responsiveness to the needs of its corporations.

takeover defenses. Unlike in the United Kingdom, U.S. managers enjoy a wide freedom when deploying defensive measures and are only constrained by the limits of a flexible business judgment rule, as elaborated in *Unocal Corp. v. Mesa Petroleum Co.*<sup>172</sup>

The particular case provided a set of criteria for courts to follow in reviewing takeover defenses. Recognizing the possibility of self-interest on the part of the directors, the court required the directors to show that (a) “they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed” and (b) the defense was “reasonable in relation to the threat posed.”<sup>173</sup> The court considered that the directors had met this test and upheld the validity of Unocal’s defensive self-tender offer aimed at frustrating Mesa’s coercive, two-tier bid. In *Moran v. Household International Inc.*, the court declared that both the adoption and the board’s refusal to redeem the pill would be subject to the *Unocal* test and validated the poison pill adopted by Household.<sup>174</sup>

In *Paramount Communications, Inc. v. Time Inc.*, the court stressed the flexibility with which the *Unocal* test should be applied and voted against a “mechanistic procedure.”<sup>175</sup> Delaware courts in previous decisions<sup>176</sup> had endorsed the view that only two kinds of threats could fulfil the first limb of *Unocal*: the threat of “structural coercion” posed by two-tier bids, which result in unequal treatment of shareholders, and the threat posed by the inadequate value of the offer.<sup>177</sup> The Supreme Court of Delaware disapproved of this approach.<sup>178</sup> Moreover, it was accepted that Paramount’s offer for Time presented a threat to Time’s corporate policy and plan.<sup>179</sup> According to *Paramount*, directors are able to fend off an unwanted bidder and pursue their corporate plans, “unless there is clearly no basis to sustain the corporate strategy.”<sup>180</sup> Consequently, it seems perfectly rational to argue that *Paramount* suggested “that the right to reject a hostile bid was close to absolute.”<sup>181</sup> Concerning the second limb of the *Unocal* test, *Unitrin, Inc. v. American General Corp.* highlighted the latitude

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<sup>172</sup> 493 A.2d 946, 954–55 (Del. 1985).

<sup>173</sup> *Id.* at 955.

<sup>174</sup> 500 A.2d 1346, 1350 (Del. 1985).

<sup>175</sup> 571 A.2d 1140, 1153 (Del. 1989).

<sup>176</sup> *See, e.g.*, *City Capital Assocs. Ltd. P’ship v. Interco Inc.*, 551 A.2d 787, 797 (Del. Ch. 1988).

<sup>177</sup> *Id.* at 797–99.

<sup>178</sup> *Paramount*, 571 A.2d at 1153.

<sup>179</sup> *Id.* at 1153–54.

<sup>180</sup> *Id.* at 1154.

<sup>181</sup> *Bebchuk et al., supra* note 49, at 906.

that directors enjoy.<sup>182</sup> The defensive measure will satisfy the second limb of the *Unocal* test (reasonableness test) if it is not draconian, meaning that it should not be coercive or preclusive, and is within “a range of reasonableness.”<sup>183</sup> The vagueness of the range of reasonableness test makes its satisfaction much easier.

In conclusion, state and common law have erected a plethora of barriers to hostile raiders. Whilst anti-takeover statutes have inserted new takeover defenses, such as business combination statutes, the courts have repeatedly denied setting any objective standards on the basis of which management’s actions will be reviewed. Instead, they have ruled in favor of wide discretion of the board and an open-ended approach.

### B. *The Foundations of the Managerialistic Stance*

Lipton, the inventor of the poison pill, in an influential article published in 1979, passionately defended the power of managers to block hostile bidders.<sup>184</sup> The power to decide on a takeover should rest with the directors, who, apart from shareholders’ short-term financial interests, should also take into account the long-term impact of the takeover, not only on the shareholders and the company, but also on other stakeholders, such as employees, suppliers and the like.<sup>185</sup> A necessary intergradient of a successful economy, that is long-term planning, would be menaced if directors had to obey the choices of profit-seeking shareholders.<sup>186</sup> This line of reasoning suggests that takeovers are not always beneficial and can impose major costs. Layoffs of employees, reduction in competition and stagnation of R&D investment are but a few of the negative externalities they generate.<sup>187</sup>

Another argument in favor of granting management the power to fend off bids is that a board, armed with takeover defenses, will be able to

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<sup>182</sup> 651 A.2d 1361 (Del. 1995).

<sup>183</sup> *Id.* at 1387–88 (citations omitted).

<sup>184</sup> Martin Lipton, *Takeover Bids in the Target’s Boardroom*, 35 BUS. LAW. 101 (1979). Proponents of board power to block takeovers embrace the “entity” conception of the corporation. *Id.* at 112. Corporations should be run not only in the interest of shareholders, but also in the interest of all other corporate constituencies including employees, the communities in which corporations conduct business and creditors. *Id.* at 115. The board of directors is entrusted with balancing these competing interests and generating long-term value for all the constituencies. *Id.*

<sup>185</sup> *Id.* at 105–06, 110, 115.

<sup>186</sup> *Id.* at 104–05.

<sup>187</sup> Janice Dean, *Directors’ Duties in Response to Hostile Takeover Bids*, 14 INT’L COMPANY & COM. L. REV. 370, 376–77 (2003).

negotiate a better price for shareholders. Given the collective action problems that investors face, only the board may act as a centralized negotiator. Indeed, Mark Gordon argues that takeover defenses strengthen the negotiating power of boards, which in turn allows boards to extract higher premia, not only in hostile takeovers but also in friendly deals, “because the target can more effectively counter the acquirer’s implicit threat to ‘go hostile’ if its various demands are not met.”<sup>188</sup> However, Subramanian suggests that this hypothesis is valid only in relation to a subset of negotiated takeovers.<sup>189</sup>

In light of the current financial crisis, the most plausible argument supporting the primacy of directors is the rejection of the “efficient capital market hypothesis.”<sup>190</sup> Based on the assumption that “share prices accurately reflect the intrinsic value of a corporation,”<sup>191</sup> supporters of this theory, most notably Easterbrook and Fischel, assert that a bid over the market price will always be above the true value of the company and, consequently, beneficial for shareholders.<sup>192</sup> Accordingly, the board should never be given the power to hamper bids. As already mentioned, the current turmoil in the markets attenuates the validity of this theory and, in fact, shows that shares can be mispriced. Since shares may be undervalued, namely traded below the true value of the firm, informed managers, who know better about the firm’s true value, should be armed with a veto power in order to protect shareholders from inadequate offers. That is, offers that may seem beneficial, as being above share price, are in fact coercive and devastating to shareholders because they are below the firm’s “intrinsic” value.

Lastly, the ultimate rationale underpinning the courts’ and the states’ willingness to grant a broad authority to managers is the prevalence of managers, and not shareholders, in the governance of the firm. In order to better understand takeover law in the United States, one should first bear in mind this “director primacy”<sup>193</sup> model of corporate law.

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<sup>188</sup> Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 823 (2002).

<sup>189</sup> Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 623 (2003).

<sup>190</sup> Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1, 1 (2002).

<sup>191</sup> *Id.* at 7.

<sup>192</sup> Easterbrook & Fischel, *supra* note 146, at 1165–67.

<sup>193</sup> Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 794–95 (2002).

*C. Transplanting the U.S. Regime into the United Kingdom*

We have already set forth the U.K. takeover regime as it applies to takeover defenses. The rigidity of the regime reveals the traditional “shareholder primacy” model prevailing. Pre-bid defenses are regulated by directors’ fiduciary duties, whereas post-bid defenses are totally interdicted, unless shareholders approve them. On the contrary, no such ban on post-bid defenses exists in the United States. Boards may freely deploy defenses against unwanted bids, subject only to the *Unocal* test, which, as indicated above, is laxly applied by the courts. A question naturally arises. Should the United Kingdom abandon its strict “board neutrality” regime and mimic the U.S. model, namely grant the courts the authority in deciding on defensive actions in the face of a bid? Besides, the U.S. economy is more successful than the British one, and it incorporates some of the most competitive firms in the world, without giving bidders an unqualified right to acquire another company. Our answer would be no, yet our argument goes beyond the traditional shareholder/director choice debate. Our argument focuses only on costs. Thus, we will insist that the current U.K. post-bid prohibition achieves the best results at a minimum cost.

In considering first the costs that a transplantation of the U.S. regime would entail, shifting the authority to the courts will inevitably bring back litigation in the takeover arena, an option that is largely restrained by the current regime. Litigation generates costs for bidders, targets and shareholders. The costs will take the form of lawyers’ and investment bankers’ fees, which will be substantial in high-profile cases. In addition, litigation will delay the closing of a bid. Armour and Skeel offer as an example the battle between Oracle and Peoplesoft, which ended with the prevalence of Oracle, but only after an eighteen-month saga.<sup>194</sup> Such a delay is devastating for both the bidder and the target. Markets demand players to move quickly in order to survive. Litigation will delay the successful integration of the two companies and give competitors time to adapt to the new situation.

Furthermore, U.K. courts will probably resort to the proper purposes doctrine, currently used for scrutinizing pre-bid defenses, when reviewing post-bid defenses. Thus, we will move from a bright and clear rule, promoting certainty in the takeover market,<sup>195</sup> to a “detailed examination of the factual context in which a decision was taken in order to ascertain the purposes behind it.”<sup>196</sup> As Johnston observes, uncertainty will

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<sup>194</sup> Armour & Skeel, *supra* note 64, at 1747.

<sup>195</sup> THE TAKEOVER CODE, *supra* note 7, at Rule 21.1.

<sup>196</sup> Johnston, *supra* note 28, at 436.

be the result of such an approach.<sup>197</sup> This will surely impede the development of the takeover market. A central key for the function of markets is certainty. An unpredictable regime governing defensive tactics will deter bidders from launching takeovers. This will also be the case for foreign bidders too, causing the United Kingdom to lose considerable amounts of foreign investment. Another possible danger is that uncertainty will cause disruption to the operation of both firms. Consider the confusion caused to consumers, employees and suppliers who will have to wait for the court's decision on whether the defensive measures are valid and, consequently, on whether the bidder will succeed.

Additionally, the adoption of defenses is associated with considerable costs itself. For instance, a white squire defense will involve the costs of a share issue. Another point of concern is the damage that litigation will cause to both firms, since the trial will usually involve allegations of incompetency or self-interest from both sides. Therefore, a decline in the price of the shares of both companies cannot be excluded.

Once one moves to the current U.K. regime these costs disappear. Nevertheless, the flat ban imposed generates others. First, there is a possibility that shareholders, without the guidance of directors, will accept an inadequate offer. However, the majority of shares in the United Kingdom are held by institutional investors,<sup>198</sup> who are more informed and sophisticated than an individual investor. As a result, the problem is unlikely to be serious. Another potential concern stems from the costs deriving from a "one size fits all approach," namely that *under any circumstances* defensive measures are banned. One cannot totally rule out the possibility of shareholders, even sophisticated ones, accepting an unbeneficial offer. Therefore, a flat ban on directors' defensive actions will leave them unprotected. Nonetheless, even if the offer is devastating for shareholders' interests, then directors may provide shareholders all the information necessary to convince them that they should reject the offer.<sup>199</sup>

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<sup>197</sup> *Id.*

<sup>198</sup> Domestic institutional investors hold around sixty percent of publicly traded shares, while overseas investors hold about twenty percent. JOHN FARRAR, CORPORATE GOVERNANCE: THEORIES, PRINCIPLES, AND PRACTICE 364 (3d ed. 2008).

<sup>199</sup> *See* Air Prods. & Chems. Inc. v. Airgas Inc., 16 A.3d 48, 106 (Del. Ch. 2011). The dispute arose after the hostile takeover offer of Air Products for Airgas. *See generally id.* Armed with a staggered board and a poison pill, Airgas directors strongly resisted the offer for over sixteen months. *Id.* at 107. Subsequently, Air Products sued seeking to compel Airgas directors to redeem the poison pill. *Id.* at 56. Although Chancellor Chandler, constrained by Delaware Supreme Court precedent, ruled in favor of Airgas, allowing it to maintain its poison pill, he

Hence, the circumstances in which shareholders will accept a value-minimizing bid will be rare indeed.

Other costs include the costs imposed on society by major layoffs and reduction in competition.<sup>200</sup> Concerning the latter, draconian national and European competition laws solve the problem. Certainly, takeovers are usually associated with layoffs. Still, layoffs may be inevitable even if a takeover does not occur. Takeovers are largely driven by the need to enhance the competitiveness of the firm, either by creating economies of scale or by expanding the business of the company. Absent a restructuring, firms are likely to decline, thus resulting in employee dismissals, especially in case a firm is forced to declare bankruptcy. Moreover, this argument is associated with a wider concern about the limits of the profit-maximizing nature of the corporation. Even if managers were allowed to erect takeover defenses, then under section 172 of the Companies Act 2006, their main goal would still be profit maximization, and they would still owe a duty only to shareholders and not to other stakeholders.<sup>201</sup> Therefore, they wouldn't be able to put the interests of stakeholders ahead of shareholders' interests and forestall a takeover solely because it would lead to major layoffs.

In conclusion, the genius of the U.K. regime lies in its ability to achieve the best results at a minimum cost. It manages to promote certainty, a vibrant takeover market and accountability of directors, while eliminating the costs generated by litigation. In addition, the costs imposed by the ban on takeover defenses are either insignificant or associated with a wider debate outside the takeover field and in the realm of core U.K. corporate law, which firmly adopts the shareholder value maximization norm.

## VII. CONCLUSION

Our article has attempted to illustrate the regulation of takeover defenses in the United Kingdom and the rationale underpinning it and present a convincing case against the adoption of the U.S. regulatory model. Thus, we have abstained from the traditional shareholder/director primacy debate and resorted to a comparative assessment of the costs generated by

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strongly voiced his view that Airgas' pill had served its legitimate purpose. *Id.* at 57. The pill had given Airgas' director over a full year to disseminate information to shareholders and express its view on the offer. *Id.* As a result, shareholders had all the necessary information before them to reach an informed decision. *Id.*

<sup>200</sup> Dean, *supra* note 187, at 376.

<sup>201</sup> Blanaid Clarke, *Directors' Duties During an Offer Period—Lessons from the Cadbury Plc Takeover* 4 (UCD Working Papers in Law, Criminology & Socio-Legal Studies, Paper No. 44/2011, 2011), available at <http://ssrn.com/abstract=1759953>.

each regime. Even though the former debate remains a vibrant one and largely unresolved,<sup>202</sup> we have endeavored to show that the current regime attains optimal results whilst surmounting the considerable costs of the U.S. model. Further, the costs imposed by Rule 21 of the Takeover Code are either insignificant or associated with a wider debate outside the takeover field.

Nevertheless, it should be stressed that the question relating to the implementation of the U.S. regime in the United Kingdom remains a theoretical one. The approach of British takeover regulation, even after the Kraft-Cadbury fight, is clear. Shareholders alone should have the power to assess the merits of a takeover offer and decide on its success. This shareholder primacy model is firmly rooted in U.K. takeover regulation and corporate law, so that a change towards a U.S.-style regulatory model should not be expected.

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<sup>202</sup> See Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. (2013) (forthcoming Oct. 2013); see also Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) (arguing against director primacy and in favor of the expansion of shareholder rights). On the opposite side, Lynn Stout and Margaret Blair have offered the most coherent and articulate defense of the entity conception of the corporation and director primacy. Their team production theory entrusts the board of directors with allocating the economic surplus generated by the efforts and firm-specific investments of the various corporate constituents including executives, employees, creditors and shareholders. Absent the mediating authority of the board, the various corporate team members would have incentives to engage in value-decreasing shirking and opportunistic rent-seeking. See generally Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719 (2006); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 248 (1999).