European Takeover Law: Designing a Neutral Approach

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Abstract

This paper argues that in revising the Takeover Bid Directive, EU policymakers should adopt a neutral approach toward takeovers, i.e. enact rules that neither hamper nor promote them. The rationale behind this approach is that takeovers can be both value-creating and value-decreasing and there is no way to tell ex ante whether they are of the former or the latter kind. Unfortunately, takeover rules cannot be crafted so as to hinder all the bad takeovers while at the same time promoting the good ones. Further, contestability of control is not cost-free, because it has a negative impact on managers' and blockholders' incentives to make firm-specific investments of human capital, which in turn affects firm value. It is thus argued that individual companies should be able to decide how contestable their control should be. After showing that the current EC legal framework for takeovers overall hinders takeover activity in the EU, the paper identifies three rationales for a takeover-neutral intervention of the EC in the area of takeover regulation (pre-emption of "takeover-hostile," protectionist national regulations, opt-out rules protecting shareholders vis-à-vis managers' and dominant shareholders' opportunism in takeover contexts, and menu rules helping individual companies define their degree of control contestability) and provides examples of rules that may respond to such rationales.

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1. Introduction

The *Takeover Bid Directive*[1] (TBD) contains a revision clause: around May 2011 the *Commission* shall "examine this Directive in the light of the experience acquired in applying it and, if necessary, propose its revision. That examination shall include a survey of the control structures and barriers to takeover bids that are not covered by this Directive"[2]. May 2011 is approaching: it cannot be too early to start a debate on the future of European takeover law.

Both before and after the adoption of the TBD, the policy debate on European Takeover law has almost exclusively focused on how contestable European companies should be.[3] Commentators generally agree that "[t]he true main goal of the Takeover Directive [is][] the maximization of takeovers – i.e. the facilitation of as many takeovers as 'the market' desires."[4] If that is true, then the TBD was indeed a spectacular failure, much less for what it did not do (it failed to impose the board neutrality rule and the break-through rule) than for what it positively did. In fact, as section 3 and 4 show, many EC rules hinder takeover activity rather than promoting it. That is because in general policymakers have a tendency to enact rules that protect incumbent managers or controlling shareholders from the market for corporate control. Such a pro-incumbent approach has so much characterized national takeover laws in the past decades that the starting point for EC intervention in the area was one displaying a number of national anti-takeover measures. It was only natural for the EC to include them in the TBD in its attempt to provide a single EU-wide legal framework for takeovers. By doing so, however, it took national anti-takeover provisions under its wings, thereby

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[1] *Directive 2004/25/EC on Takeover Bids of 21 April 2004*, OJ L 142, 30.4.2004, p. 12–23.
[2] Article 20 TBD.
[3] See e.g. *Klaus J. Hopt, Takeover regulation in Europe -- The battle for the 13th directive on takeovers*, 15 AUST. J. CORP. L. 1 (2002); *Vanessa Edwards, The directive on takeover bids – Not Worth the Paper it's Written on?*, 1 ECFR 416 (2004).
[4] *Beate Sjåfjell, Towards a Sustainable European Company Law* 166 (2009).

extending them to all EU (and EEA) states and petrifying them at least until the review of the TBD[5].

When the time for the review of the TBD comes, the *European Commission* will predictably try to push for more mandatory rules, such as the ones it failed to impose in 2004, to tilt the current legal framework in the direction of more contestability (I call this possible outcome an "enhanced TBD regime"). It is highly unlikely that a similar attempt will be more successful then: national governments' protectionist instincts have strengthened since 2004.

This contribution outlines an alternative regulatory approach to takeovers with specific reference to the EC framework. It argues that EC law should adopt a consciously neutral approach to takeovers, i.e. it should aim neither to make European companies easier to take over nor hinder the functioning of the market for corporate control by making takeovers more costly and therefore more rare. Section 2 articulates this claim based on the hardly contestable proposition that takeovers as such are neither good (value-creating) nor bad (value-destroying): there are good and bad takeovers, but takeover rules cannot be crafted so as to hinder all the bad ones while at the same time promoting the good ones. After showing that EC rules are overall "takeover-hostile" in Sections 3 and 4, Section 5 illustrates how a takeover-neutral EC legal framework would look like. Section 7 concludes.

2. The economic rationale of a neutral approach

Takeovers, both friendly and hostile, are neither intrinsically good nor intrinsically bad: they may create value or destroy it. Unfortunately, whether a given takeover is value-increasing or value-decreasing is only known for sure after it has gone through.

Takeovers perform two functions: they discipline managers and reallocate control. Let us first consider takeovers as a discipline device. Their positive effects on managerial agency costs are

[5] On the petrification effect of EC (company) law see *Richard M. Buxbaum* and *Klaus J. Hopt*, *Legal Harmonization and The Business Enterprise* 243 (1988)..

impossible to quantify, if only because it is the mere possibility of a takeover that aligns managers' interests to those of shareholders. While these benefits may be substantial,[6] the empirical evidence shows that hostile takeovers that do occur are not targeted at underperforming companies.[7] Further, this disciplinary device also has a negative side. The threat of hostile takeovers does not allow managers to protect their firm-specific investments, which are potentially valuable also for shareholders (and other stakeholders as well). If managers face the risk of being ousted following a hostile takeover, they will tend to make less human capital investments of this kind.[8]

The second function of takeovers (control reallocation) is equally important, but unfortunately this market is far from perfect. Shareholders' collective action problems on the one hand and the presence of private benefits of control on the other can lead both to the success of value-decreasing takeovers and to the failure of value-increasing ones.

Shareholders' collective action problems can distort the outcome of takeovers because of the free riding problem. A prospective acquirer will launch a tender offer if the gains exceed the costs. In principle, this is done by identifying undervalued companies, bidding for all of their stock at a price (slightly) above the current one, and, after the purchase, profiting from bringing stock returns to full potential.[9] Unfortunately, due to target shareholders' collective action problems, this strategy is almost impossible to implement. Anticipating the higher stock returns, an individually rational shareholder prefers not to tender hoping that the other shareholders will, so as to free ride on the takeover gains.[10] Dispersed shareholders, being unable to coordinate, will all think the same, leading to the takeover failure. That is, unless, of course, the bidder offers them the entire expected

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[6] See most recently *Jonathan R. Macey, Corporate Governance: Promises Kept, Promises Broken*, 118-122 (2008).

[7] Empirical studies of hostile takeovers are only available for the US and the UK. See, respectively, *G. William Schwert, Hostility in Takeovers: In the Eyes of the Beholder?*, 55 J. FIN. 2599 (2000); *Julian Franks, Colin Mayer, and Luc Renneboog, Who Disciplines Management in Poorly Performing Companies?*, 10 J. FIN INT. 209 (2001).

[8] For an overview of the literature see *Marco Becht, Patrick Bolton,* and *Ailsa Röell, Corporate Law and Governance,* in *A. Mitchell Polinsky and Steven Shavell (Eds), Handbook of Law and Economics*, 833, 851-852 (2007).

[9] This is how the market for corporate control was first understood. See *Henry G. Manne, Mergers and the Market for Corporate Control*, 76 J. POL. ECON. 110 (1965).

[10] This problem was first discussed analytically by *Sanford J. Grossman* and *Oliver D. Hart, Takeover Bids, The Free-Rider Problem and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980).

post-takeover value increase. But that would deprive the bidder of any profit, which means that she will not launch the bid to begin with.

Free riding is less severe than that in the real world, but the substantial gains accruing to target shareholders are evidence of its existence.[11] One prominent reason why the free riding problem is not as extreme as theory predicts is that target shareholders face a second collective action problem, i.e. pressure to tender[12]. Because they decide whether to tender based on the expected post-takeover value relative to the bid price, bidders can force shareholders to tender by "fixing" a post-takeover value for holding-out shareholders lower than the bid price. One way to implement this strategy is by declaring in advance that after the takeover the target company will be merged into the parent company on the basis of an exchange ratio that values the target shares less than the bid price (that, of course, in jurisdictions where company and securities laws do not forbid a similar merger). While such a bid structure effectively solves the free riding problem, it prompts dispersed target shareholders to accept even bids in which the expected post-takeover value is lower than the pre-acquisition value. In other words, it makes even value-decreasing bids possible.[13]

All major jurisdictions, including EU ones and the EC itself, provide for rules that aim to solve the pressure to tender problem. In doing so, however, they bring back the free riding problem to the foreground and therefore negatively affect value-increasing bids. They also make all tender offers more costly, and therefore less profitable for bidders. At the margin, thus, they have a negative impact on value-increasing takeover bid activity.

An alternative to laws aimed to protect target shareholders against pressure to tender is to let individual companies themselves devise contractual solutions to it, such as charter provisions granting a majority of the shareholders or the corporate board a veto over the transactions. A private ordering solution to the free riding and pressure to tender problems has the great advantage of

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[11] See *Burkart* and *Panunzi*, *Takeovers*, ECGI Finance Working Paper No. 118/2006, 12-17.

[12] See e.g. *Lucian A. Bebchuk, The Pressure to Tender: An Analysis and a Proposed Remedy,* in 12 DEL. J. CORP. L. 911 (1987).

[13] See e.g. *Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance and Takeovers,* 76 AM. ECON. REV. 323 (1986).

allowing for adaption of the response to the specific characters of each individual company. Whether a company's control should be more or less contestable is in fact a function of a number of variables, such as its ownership structure, the levels and kind of private benefits available to those in control and the importance of managerial firm-specific investments. A company's shareholders, whether at the IPO stage or mid-stream, are ultimately in the best position to strike the balance between all such variables. A one-size-fits-all solution devised by lawmakers will inevitably make some companies more open to the market for corporate control, and some others too protected from its disciplining and/or re-allocation effects, than it would be optimal.

The framework is different in the presence of a controlling shareholder, but again control transfers can be value-creating as well as value-decreasing and the conclusion to be reached is the same as before, i.e. private ordering is better than one-size-fits-all solutions. Here, changes in control are normally operated by voluntary exchanges of the controlling block.[14] The main problem is that the acquirer's gains can come from the extraction of higher pecuniary private benefits of control and/or from better management, synergies and so on. If the difference between the seller's private benefits of control and the acquirer's is significant enough, the acquirer can profit from the transaction even if the overall value of the company under her control is lower than under the seller's. In other words, the acquirer's gains can be the minority shareholders' losses. A solution to this problem is the mandatory bid, which forces the acquirer to extend to minority shareholders the same terms of purchase offered to the seller, thereby ruling out inefficient takeovers. Unfortunately, the mandatory bid also reduces the number of successful value-increasing takeovers, because of the additional costs of paying the control premium to minority shareholders.

The negative impact of mechanisms protecting minority shareholders from expropriation in negotiated control transfer settings generally depends on the relative importance of private benefits

[14] For a comprehensive analysis of this setting, see *Lucian A. Bebchuk, Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957 (1994).

of control for the seller and the acquirer,[15] which in turn depends on factors like ownership structure, the company's business, the regulatory environment, and so on. Then, again, the decision on whether to sacrifice efficient allocation of corporate control in the name of investor protection (or vice-versa) should be left to individual companies.

To conclude, takeover regulation should be as neutral as possible, i.e. be designed in such a way as to neither hamper nor promote takeovers. This implies mainly deferring to private parties' choices, but there still is a role for the law to play, and especially for EC (or federal) law, as section 5 shows. Before describing how a takeover-neutral EC law would look like, let us see how distant current EC law is from this approach.

3. The current EC approach: (1) the few rules promoting takeovers

As we have seen in the previous section, the market for corporate control and hostile takeovers more specifically are well known to be highly effective in disciplining managers and are thus a powerful market-based tool to indirectly protect the interests of shareholders. Further, a market in which hostile takeovers can more easily succeed is also one in which cross-border acquisitions will be more frequent, and thus a more integrated one. Rules promoting takeovers are thus justified both because they indirectly protect the interests of shareholders (Article 44(2)(g), *EC Treaty*) and because they are instrumental to market integration, one of the foundations of the *European Union*. It is thus surprising how few the provisions of this kind are in *EC Directives*. Here is the list:

a. Articles 9, 11, and 12 of the TBD, requiring Member States to at least allow companies to opt for the board neutrality rule and the break-through rule;[16]

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[15] For instance, inefficient control transfers are bound not to happen when the seller's and the acquirer's private benefits are of the same order of magnitude. In this situation, the mandatory bid has only adverse consequences on value-increasing takeovers. See *Mike Burkart* and *Fausto Panunzi*, *Mandatory Bids, Squeeze-Out, Sell-Out and the Dynamics of the Tender Offer Process*, in *Guido Ferrarini, Klaus J. Hopt, Jaap Winter and Eddy Wymeersch* eds., *Reforming Company and Takeover Law in Europe*, 737, 761 (2004).

[16] To be sure, Article 3(1)(c) TBD spells out the principle that "the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the

b. At least if broadly construed, the *Second Company Law Directive*'s provisions on pre-emptive rights and equal treatment (Articles 29 and 42) rule out the possibly most effective defensive device, i.e. the US-style poison pill;[17]

c. The *Second Company Law Directive* itself makes it harder for boards to adopt other defensive strategies, such as leveraged cash-outs (due to limits on distributions and rules requiring a shareholder meeting resolution on buy backs)[18], targeted issues of shares (via rules requiring a shareholder meeting resolution to restrict or withdraw pre-emptive rights provisions)[19], and to execute leveraged management buy-outs[20];

d. Article 46 of *Directive 2001/34/EC* provides that shares admitted to official listing must be freely negotiable (para. (1)). A derogation to this principle, in the form of an approval of purchases of shares e.g. by the board, is only allowed "if the use of the approval clause does not disturb the market" (para. (3)), a sufficiently vague formulation as to make board approval even of purchases of shares above a given threshold of dubious legality;[21]

e. Article 10 of the TBD, requiring companies to provide detailed information on their ownership structures and any anti-takeover devices, thus lowering the costs potential bidders have to incur to identify targets;

f. Article 15 of the TBD, requiring Member States to grant bidders squeeze-out rights at certain conditions;

bid." It is doubtful, however, whether this principle has any operational value in the law in action for any company that is not subject to Articles 9 and 11. Similarly, the fact that the board neutrality and break-through rules are the "EC" default means these rules have hardly any operational impact, because *Member States* can opt out.

[17] See e.g. *Jeffrey N. Gordon*, *An American Perspective on Anti-Takeover Laws in the EU: The German Example*, in *Guido Ferrarini, Klaus J. Hopt, Jaap Winter and Eddy Wymeersch* eds., *Reforming Company and Takeover Law in Europe*, 541, 551 n23 (2004).

[18] See Articles 15 (limits on distributions) and 19-22 (buy-backs).

[19] Article 29(4), *Second Company Law Directive*. See also Article 29(5) of the same, which allows *Member States* to delegate the power to restrict or withdraw pre-emption rights to the body that has been delegated to issue new shares.

[20] Article 23a, *Second Company Law Directive*.

[21] Cf. *Guido Ferrarini*, *Le difese contro le o.p.a. ostili: analisi economica e comparazione*, 2000 *Rivista delle società* 737, 746 (describing national listing requirements requiring free transferability of shares and noting that the original intent of the EC provision was not to promote takeovers).

g. Article 3 of *Regulation (EC) No. 2273/2003*, identifying the eligible purposes a company may pursue in order to be exempted from the market abuse prohibitions (safe harbour).[22] Defending against a hostile bid is not one of them. Although operating outside the safe harbour should not *per se* be regarded as abusive, it entails a higher legal risk, therefore discouraging buy-backs as a defensive measure.

4. The current EC approach: (2) the many rules hindering takeovers

We have seen that takeover bids can also harm shareholders' interests by exploiting the collective action problem of the target shareholders as against the bidder. Other stakeholders, like creditors and employees, may also stand to lose if a takeover bid succeeds.[23] Under the implicit assumption that private parties themselves have no more efficient ways to address these problems, the TBD contains a number of provisions that, while providing safeguards for shareholders and other stakeholders, have a negative effect on takeover activity. Some provisions in other directives also have this indirect effect. Starting first with the TBD, here is a list of its "takeover-hostile" provisions:

a. By providing for equivalent treatment of securities holders of the same class,[24] the TBD appears to rule out the possibility of price discrimination and selective purchases at a higher price during the bid, which might otherwise help bidders lower the acquisition price and/or raise their chance of success;

b. In the context of hostile bids, the mandatory bid rule[25] prevents the bidder from using coercive bid structures such as partial offers (albeit only above the mandatory bid rule threshold, which is for the Member States to define) and two-tier tender offers (whereby

[22] Art. 3 of *Commission Regulation (EC) No. 2273/2003 of 22 December 2003*.
[23] See *Paul Davies* and *Klaus Hopt, Control Transactions*, in *Reinier Kraakman et al.*, *The Anatomy of Corporate Law*, 225, 229-30 (2d ed., 2009).
[24] Article 3(1)(a).
[25] Article 5.

the price for the second stage of the offer is lower than for the first stage).[26] The mandatory bid rule also makes friendly acquisitions more costly: at the margin, some value-creating transactions may not go through because of such higher costs;[27]

c. The TBD requires a minimum acceptance period of two weeks.[28] The provision raises the cost of acquisitions for bidders in various ways. First, it rules out coercive bids such as the notorious 1960s "Saturday Night Special," an offer launched on Friday night and closing on Monday morning before stock exchange opening[29]. Second, the provision facilitates incumbent boards' reaction. Specifically, it raises the probability of a competing offer, whether by a White Knight or by another third party. Finally, and less importantly, a longer offer period implies higher financing costs;

d. The Directive also requires bidders to submit a detailed offer document for authorization by the competent supervisory authority and to make it public,[30] which has obvious costs, both direct and indirect (especially as regards the risk of liability suits and administrative or even criminal sanctions for incomplete or false information), and further delays completion of the transaction;

e. By requiring immediate disclosure of the intention to launch the bid,[31] the Directive restricts bidders' discretion in deciding when to start their attack, possibly with negative implications, again, on the cost side and the chance of success. Specifically, it may hamper the bidder's ability to build a sufficiently high toehold before share prices incorporate information about the transaction. Further, it gives the target company more time to prepare defences or to find a White Knight;

f. The effect of curbing coercive practices and therefore of raising acquisition costs stems also from granting a sell-out right to remaining shareholders after highly successful

[26] See e.g. *Paul Davies* and *Klaus Hopt*, *Control Transactions*, *supra* note 23, at 252-4.
[27] *Id*. at 259.
[28] Article 7(1).
[29] See e.g. *Ronald J. Gilson* and *Bernard S. Black*, *The Law and Finance of Corporate Acquisitions* 734 (1995).
[30] Article 6.
[31] Article 6(1).

completion of the bid (the threshold being between 90 and 95 percent, depending on States' choice). This is in fact like a second round as envisaged by the takeover regulations of some countries to avoid pressure to tender[32];

g. While requiring Member States to include squeeze-out provisions in their takeover laws, the TBD prevents them from granting such right in broader terms than it envisages. For instance, Member States may not allow successful bidders to squeeze-out minorities after reaching a threshold lower than 90 per cent, again with a negative impact on takeover activity;

h. Finally, and least importantly, even the rule that requires target companies to "make public a document setting out its opinion of the bid" has an albeit trivial negative impact on takeover activity, because it requires target companies to bear the cost of preparing and publishing the document. Of course, target companies would always try to communicate with shareholders in the event of a hostile takeover. But they might keep silent when the bid is friendly.

At least two other pieces of EC company law are to mention as "takeover-hostile." First and foremost, the *Transparency Directive* provisions requiring holders of stakes higher than 5 percent to inform the public about their stakes and any subsequent material change[33] have an apparent negative impact on takeover activity, as it directly affects the possibility of building toeholds while the market is still in the dark about a raider's intentions.[34] Second, the *Second Company Law Directive* provides for particularly "onerous conditions"[35] for the legality of financial assistance transactions, thus curbing leveraged buy-out activity, however little, at the margin.[36]

This Section and the previous one have briefly outlined the pieces of EC takeover regulation that either promote or hamper takeover activity. There was of course no pretence to cover

[32] See e.g. Rule 31.4 of the the UK Takeover Code; for Germany, § 21(5) WpÜG.
[33] Articles 9 and 10, *Transparency Directive*.
[34] See e.g. *Lucian A. Bebchuk, The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982).
[35] Article 23. See critically *Eilís Ferran, Regulation of Private Equity - Backed Leveraged Buyout Activity in Europe* 25-30 (May 2007). ECGI - Law Working Paper No. 84/2007. Available at SSRN: http://ssrn.com/abstract=989748.
[36] See *Ibid*.

absolutely all takeover and takeover-relevant regulations. In fact, no mention has been made of the provisions, in the TBD (very few) or elsewhere, pertaining to the protection of employees.[37] While it may be argued that they also have a (very mildly) adverse impact on takeover activity, I omit them for the sake of brevity.

To summarise, the EC rules hampering takeovers are more numerous than those promoting them. Because their relative importance may vary, it may be subject to debate whether the overall outcome is one rather hindering than promoting takeovers. But it is fair to conclude that the current regime leans on the side of hampering them.

5. The building blocks of a neutral approach

I have argued that (EC) law should be neutral toward takeovers, i.e. set a framework of rules neither subsidising nor hampering takeover activity, while at the same time leaving individual companies free to choose whether and how easily their control should be reallocated, whether via a takeover bid or a sale of the controlling block by the dominant shareholder.[38]

That does not imply that there should be no EC law on takeovers, however. In fact, while most of the TBD rules making takeovers riskier and costlier or promoting them should be scrapped, harmonising measures in this area are justified on three grounds.

First, the EC's fundamental aim of promoting market integration makes it a good candidate to act as a countervailing force against Member States' tendency to devise rules that protect incumbents and therefore hinder takeover activity[39]. In other words, EC law should ideally rule out Member States' ability to issue mandatory rules of that kind.

Second, there is a clear conflict of interest between managers or blockholders and (other) shareholders in defining a company's policies vis-à-vis takeovers, whether hostile or friendly, and

[37] For a description and an assessment of such provisions see *Sjåfjell*, *supra* note 4, at 355-66.
[38] In other words, most (EC) rules in this area should be optional for private parties, whether as default rules (allowing opt-out) or menu provisions (allowing opt-in). See generally *Gérard Hertig* and *Joseph McCahery, Optional rather than Mandatory EU Company Law: Framework and Specific Proposals*, 2006 ECFR 341 (advocating a wider use of optional law by EC company lawmakers).
[39] See e.g. *Roberta Romano, The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

in implementing it. Because managers and blockholders will have the upper hand at both stages, if anything due to shareholders' collective action problems, it makes sense for a takeover-neutral policymaker to devise default rules that tilt on the side of more contestability (in management-controlled companies) and on the side of more shareholder protection (in companies with a controlling shareholder).

Third, because of the mandatory nature of many European company laws, both in general and with regard to takeovers specifically, a neutral approach to takeovers should aim to remove national company law barriers to contractual freedom in designing corporate policies on control allocation. Menu (opt-in) rules should be used for this purpose.

a. Limiting Member States' freedom to enact or retain incumbent-friendly rules. Well before the TBD, many Member States had issued rules hampering takeover activity. The EC may have a role in shaping EU takeover policy by enacting pre-empting rules, i.e. rules that limit Member States' freedom to tamper with takeovers[40]. Various pre-empting rules of this kind can be thought out. Here are three examples.

1. Because disclosure obligations for owners of major shareholdings discourage takeover activity by limiting the freedom of soon-to-be bidders to build toeholds in the target company, the EC should prevent Member States from defining too low a threshold. It should also require Member States to grant those who launch a takeover bid within, say, one month from the date when the threshold was crossed, an exemption from such obligations. Of course, EC legislation should allow individual companies freely to "opt down" to a lower initial threshold or "opt up" to a higher one. They should also let them opt out of the exemption for prospective bidders.

[40] Because of the political saliency of takeovers and of the varying preferences among national polities with regard to such transactions, it would be politically impracticable to do anything more than setting limits on Member States' takeover-hostile intervention. In other words, an outright ban on takeover-hostile national laws would be a political non-starter.

2. EC legislation should not require bidders to publish an offer document.[41] Because it has always been a hallmark of takeover legislation, it is realistic to let Member States retain this requirement. In that case, however, EC legislation should specify that national rules may not make its publication conditional upon prior authorization by the supervisory authority.[42]

3. Similarly, EC legislation should not fix a minimum offer period. It may, however, provide for a maximum length of the minimum offer period Member States might want to impose.[43]

b. Default rules protecting (minority) shareholders. The right default rules can help private parties reach better outcomes in their negotiations.[44] I follow here Bebchuk and Hamdani's intuition that "[w]henever public officials face a choice between two default arrangements, one more restrictive and one less restrictive with respect to management, erring on the side of the more restrictive arrangement would carry with it a certain important advantage,"[45] i.e. that "relatively little will be lost because both shareholders and managers will support a charter amendment opting out of this inefficient arrangement."[46] In contrast, as Bebchuk and Hamdani observe, "when opting out requires a charter amendment, if the nonrestrictive arrangement is chosen and then turns out to be inefficient, it might often persist despite its inefficiency,"[47] because managers and/or controlling shareholders might gain in private benefits more than they lose *qua* shareholders.

Because there is a trade-off between minority shareholder protection and promotion of takeovers, a neutral lawmaker should choose the default rules depending on whether investor protection or contestability is more relevant to counter the self-interested behaviour of the controlling agent. When a dominant shareholder is in place, control entrenchment prevails anyway,

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[41] Of course, companies should be free to require bidders to issue such a document.
[42] A rule of this kind would be similar to the provision in *Directives 92/49/EEC* and *92/96/EEC* that prevent Member States from requiring prior approval of "general and special policy conditions … [and] forms and other printed documents which an assurance undertaking intends to use in its dealings with policy holders." See Articles 6, 29 and 39 *Council Directive 92/49/EEC of 18 June 1992* (third non-life insurance Directive); Articles 6(5), 34 and 45 *Directive 2002/83/EC of 5 November 2002*.
[43] In that case, however, EC rules should provide that companies' charters may impose a higher or lower minimum offer period.
[44] See generally *Ian Ayres*, *Optional Law*, 142-65 (2005).
[45] *Lucian A. Bebchuk* and *Assaf Hamdani*, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U.L. REV. 489, 492 (2002).
[46] Id. at 492-3.
[47] Id. at 493.

whereas control transfers can be a form of shareholder expropriation. When managers are in control, that risk is less relevant than the adverse effects of entrenchment. Default rules should err on the side of minority shareholder protection in the former case, and on the side of contestability in the latter. Although admittedly it would be difficult to design rules the application of which depends on the company's control structure, there are three issues in takeover law that the EC would best legislate upon via default rules of this kind.

1. First, because the mandatory bid rule is a safeguard for minority shareholders in the event of opportunistic control transfers, it would make sense for the EC to craft it as a default rule. Individual companies should be free to opt it out. Of course, this may imply that a higher than optimal number of companies would be subject to the mandatory bid rule than if there was no such default. But because the current regime in the EU provides for no opt-out, under the proposed rule European companies would be at least no less open to (friendly and hostile) takeovers than they are now, and some of them may become more so.

2. Tender offers launched by shareholders already controlling the company, normally with a view to delisting it (internal tender offers), are functionally equivalent to self-dealing transactions.[48] Because collective action problems may lead shareholders to accept low-ball bids that allow dominant shareholders to appropriate a disproportionate share of the company's value, EC default rules should provide for mechanisms to protect minority shareholders, such as a separate approval of the bid by a majority of the tendering shareholders.

3. Article 9 of the TBD sets the board neutrality rule as an "EU" default, in the sense that Member States are free not to implement it even as a default, provided they allow companies to opt into it, which no one does[49]. Given managers' aspiration to be protected from takeovers on the one hand, and shareholders' collective action problems in obtaining a charter amendment, on the other,

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[48] See e.g. *Ronald J. Gilson* and *Jeffrey Gordon, Controlling Controlling Shareholders*, 152 U. PENN. L. REV. 785 (2003).
[49] See *Klaus J. Hopt, Obstacles to Corporate Restructuring: Observations from a European and German Perspective*, in *Michel Tison et al.* eds., *Perspectives in Company Law and Financial Regulation. Essays in Honor of Eddy Wymeersch*, 373, 380 (2009).

it will be much easier for a company to opt-out of the default board neutrality rule than to opt into it if "no neutrality" is the default. Therefore, Article 9 should be converted into a real default rule for EU companies: Member States would have to implement it as a default rule, and only individual companies would be free to opt out.

c. Menu rules. The mandatory structure of company law in many European countries and at the EC level can hinder individual companies' ability to devise protections against takeovers. Such protections may pursue the legitimate interests of incumbent managers or dominant shareholders, who might want stability of control as a *quid pro quo* for firm-specific human capital investments and/or for management monitoring. They may also aim to solve shareholders' collective action problems vis-à-vis takeover bids. And they may do both.

The EC should enact menu rules that allow individual companies to deviate from the legally defined (and in some countries legally mandated) degree of control contestability. For example, EC legislation should require Member States to allow companies to grant the board of directors a veto power on takeover bids or any other equivalent mechanism (like a poison pill).[50] A provision like that would be extremely useful to permit companies that opted out of the board neutrality rule not to enter potentially harmful courses of action (such as leveraged cash-outs) to fend off hostile bids, because a veto power or a poison pill are, as *Jeffrey Gordon* put it, like a neutron bomb, "destroying" bids while leaving the company operationally untouched.[51] Opening to this kind of defences would allow EC policymakers to leave *Second Company Law Directive* restrictions on dividends and so forth[52] in place, because the defences they hamper are simply not needed once a veto power is available. Similarly, EC legislation should require Member States to allow companies to adopt mechanisms, other than a board veto, that solve shareholders' collective action problems

[50] It should of course be possible to restrict the veto power (or use of the poison pill) to specific kinds of bids (such as coercive ones, or those with a premium lower than *x* percent above market price). A no-poison pill default would be in the same logic as *Bebchuk* and *Hamdani*'s theory of default rules in corporate law. See *Bebchuk* and *Hamdani*, *supra* note 45, especially at 513-5.
[51] See *Gordon*, *An American Perspective*, *supra* note 8.
[52] See *supra* note 18 and accompanying text. Of course, the point here is not that it would be wise to leave such rules in place (see *Luca Enriques and Jonathan R. Macey, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, (2001) 86 CORNELL L. REV. 1165), but rather that we could ignore the negative effect of such rules on takeover activity.

vis-à-vis bidders. For instance, companies should be allowed to require bidders to make bids for their shares conditional upon re-opening of the offer once it has become unconditional.

6. Conclusion

I have argued that policymakers cannot assume that takeovers, whether hostile or friendly, are necessarily good or bad. Nor can they craft takeover rules that hinder all bad takeovers on the one hand, and promote exclusively good ones on the other. As a consequence, the (EC) regulation of takeovers should aspire to be neutral. I have described how such a neutral, mainly optional framework could look like. While, as a whole, such a neutral approach would not be an easy sell for the *European Commission*, at least parts of it might be easier to enact than an enhanced TBD regime.