EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

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Takeover Bids in Europe

European capital markets are becoming increasingly integrated as a result of the introduction of the Euro, the expansion of cross-border securities investment, developments in information and communications technology, and on-going harmonization of the framework rules for capital markets. This harmonization is a result both of the European Commission's efforts to create a common regulatory framework for securities markets and banking in the EU and competition among national corporate law systems.

In this context, EU-wide rules for takeover bids have been considered vital to the objective of improving the Europe's competitiveness, notably facilitating cross-border consolidation of industry. The Commission's aim is to create a vibrant takeover market, providing mechanisms for takeovers and changes in the management of poorly run firms, and reducing the scope for management to extract private benefits. The failure of the last draft of an EU Takeover Directive to achieve a majority in the European Parliament has been considered a setback for the harmonization process. In response to this setback, the European Commission established a High Level Group of Company Law Experts to propose solutions to certain unresolved issues.

The European Shadow Financial Regulatory Committee (ESFRC) has consistently emphasized the desirability of achieving a more integrated capital market within the EU. It is our view that a programme to harmonize rules for capital markets is essential to give EU investors access to securities in all Member States on equal conditions. The determination of corporate law, however, should be largely left to the Member States, pursuant to the subsidiarity principle. Whenever the EU has departed from this principle in the area of corporate law, the results have either been inconsequential or harmful (for example, the imposition of a rigid and expensive regime of mandated capital in the Second Corporate Law Directive). By now there is considerable evidence that it is preferable to allow corporate law to retain a fair amount of flexibility by leaving its structures to competition among Member States.

In this statement, the ESFRC recommends that the EU adopt the following provisions and changes in the proposal for a 13th Directive on rules for takeover bids, in addition to those recommended on 10 January 2002 by the High Level Group of Company Law Experts:

The "break-through rule" stating that a bidder obtains control over a firm after having acquired 75 percent of its risk-bearing capital should be modified by a "grandfathering" clause allowing owners of corporations five years to adapt their charters before the break-through rule takes effect.

We recommend the incorporation of a rule into the Takeover Directive that would require Member States to enact legal provisions enabling and encouraging their courts to examine and invalidate certain contractual arrangements which serve the primary purpose of deterring takeover bids.

Whereas we consider minority shareholder protection an essential feature of securities regulation and company law, this can be achieved effectively in various ways, and not only through mandatory bid rules. Moreover, the effects of mandatory bid rules are uncertain and may vary between countries. We therefore propose that the Directive should not provide for a mandatory bid, but rather that mandatory bid rules should be subject to the subsidiarity principle.

A level playing field

The recent Report of the High Level Group takes the position that the availability of a mechanism for takeover bids is basically beneficial, and that bidders and shareholders of target companies should operate on a "level playing field", and therefore have the same opportunities throughout the EU. The recommendations issued by the Group are guided by the principles that the ultimate decision regarding the success of a takeover bid must lie with the shareholders, and that the majority of the risk-bearing capital should be able to exercise control over the target company. These principles are reflected in the following recommendations with respect to a level playing field:

- Listed companies should be required to disclose complete information about their capital and control structure.

- Although it is clearly permitted for the management and board of the target company to offer advice, they should not be allowed to take any substantive actions designed to frustrate a takeover bid unless shareholders explicitly authorize such actions after a bid. Authorization by a shareholder meeting prior to a bid to take such substantive action should not allow the board and management to deviate from a neutral position relative to the bid.

- The Directive should introduce a "break-through" mechanism allowing the bidder to obtain control over the target if a bid has been accepted by owners of 75 percent of the risk-bearing

capital, without respect to prior voting rights. Member States could set a lower break-through level.

The ESFRC welcomes and supports the general thrust of these recommendations. In particular, we endorse the principle that the regulatory framework for takeover bids should reserve to shareholders the right to take decisions on matters relating to their company's governance. The break-through rule makes it possible for the bidder to obtain control even if the target's corporate charter includes mechanisms and structures designed to frustrate bids.

However, the enforcement of the break-through rule may undermine legitimately acquired property rights of groups of shareholders. For example, the corporate charter may specify different classes of shares with different voting rights. Shareholders who acquired control when the corporate charter did not include a break-through rule are entitled to some protection against an unexpected loss of control rights. We therefore recommend a "grandfathering clause" that would give corporations a grace period of up to five years to adapt their charters before the break-through rule takes effect.

The High Level Group's Report recommends that the break-through rule should not apply to contractual arrangements with third parties or among shareholders, even if such arrangements function as barriers to takeover bids. The Report correctly assumes that third party agreements can serve perfectly legitimate purposes, in which case such arrangements should be protected. However, "poison pills" triggering obligations to the detriment of a successful bidder, or "golden parachutes" granting excessive benefits to managers and directors of the acquired company, are examples of agreements that are designed to frustrate takeover bids. We therefore recommend the incorporation of a rule into the Directive that would require Member States to enact or retain legal provisions which would enable and encourage their courts to examine these contractual arrangements, and to invalidate them on behalf of the bidder whenever they serve the primary purpose of deterring takeover bids. Such examinations can generally be carried out by courts in a matter of days.

Minority Protection

The proposed Directive of June 2001 includes a mandatory bid rule. The implementation of such a rule implies the determination of the price to be offered to shareholders after a threshold of ownership, triggering the mandatory bid, has been reached. The High Level Group defines an "equitable price" for a mandatory bid as being "equal to the highest price paid by the offeror for shares of the relevant class, whether on or off the market, during a certain period preceding the date of the acquisition of the securities by the offeror, which resulted in the change in the control of the company". The period for evaluation of the equitable price should be set by the Member States at between six and twelve months. The rule for determination of the equitable price for mandatory bids should apply only to "normal circumstances"; the Member States should be allowed to deviate

from the highest price requirement where the offeror is able to show that it would "plainly result in an unfair price".

The ESFRC considers the protection of minority shareholders an important element of well-functioning securities markets and of company law in general. Mandatory bid rules aimed at minority protection are already in operation in many EU countries. A mandatory bid rule is not, however, the only possible means of achieving minority protection. Enforcement of the fiduciary duty of controlling shareholders, and restrictions on their rights by "group of company regulations" (Konzernrecht), offer alternative ways to protect minority shareholders.

A mandatory bid rule can under some circumstances deter takeovers, as the cost of acquiring a controlling stake may increase. In other circumstances it may encourage them, however, if it forestalls a more expensive auction process. The outcome will depend on the threshold for a mandatory bid, how the "equitable" price is set, and the structure of shareholding. Given the indeterminacy of these effects, and the fact they are likely to vary between countries, we propose that the Directive should not require the introduction of a pan-European mandatory bid rule. Instead, the subsidiarity principle should apply to the determination of mandatory bid rules, including the establishment the "equitable" price in the case of a mandatory bid.