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The Challenge of the 13th Takeover Directive in the EU

Seminar and presentation of CEPS Report

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It has proven to be a difficult challenge to harmonize takeover regulation across the EU. Indeed, so difficult that after a 14-year deadlock, it still faces major obstacles and controversies. In this context, CEPS presented its Report on the harmonization and rationale of takeover regulation in the EU on March the 4th, with Frits Bolkestein and Ieke van den Burg, MEP as the keynote speakers. The Panel consisted of Erik Belfrage, Senior Vice President, Investor, Nick Bradley, Managing Director, S&P Governance Services, Standard & Poor's, Stefano Micossi, Director-General, Assomine; and Wim Philippa, Secretary General, European Roundtable of Industrialists (ERT)

In the opening speech **Frits Bolkestein** of the EC emphasized the essential role of the harmonization of takeover regulation across the EU in its capacity to draw up common rules of conduct, to increase legal certainty and to provide minority protection regime. Particularly, the speaker concentrated on the new ideas that have been incorporated into the proposal after the historical 273:273 vote in the European Parliament. The new proposal was claimed to be coherent and based on the subsidiary and proportionality principles. It also includes a clear definition of the "equitable price", introduces "squeeze out" and "sell out" rights. It rejects the concept of risk bearing capital for its vague and opaque interpretations. Moreover, the inclusion of multiple class shares would be a step in the right direction.

The principles of board neutrality and the level playing field are of utmost importance. The Commission has chosen two ways. The first is to provide general pre-bid information on listed companies to increase transparency of their capital and control structures. The second is the "mini break-through rule" as opposed to unconditional break-through rule proposed by the Winter Group. The Commissions approach is i) to make void any restrictions on the transferability of shares to allow the bidder to have access to the shares concerned, ii) to abolish restrictions on voting rights in order to fend off against defensive measures and allow those entitled to vote in proportion of their holdings, iii) to annul structural defensive measures and change the board of the target upon acquisition of a threshold set by national company law.

More level playing field would enhance better use of resources despite the doubts that the rule violates shareholder democracy and decision making on the one hand and is capable of decreasing the value of the target and economic efficiency on the other hand. It was argued that conducive to the optimal allocation of resources the long-term objective of the level playing field is one-share one-vote regime. The latter would promote shareholder democracy and achieve single, integrated and liquid securities market in the European Union.

The coming weeks would be crucial for finding a solution. The new proposal will be presented to the Competitiveness Council in the 2nd half of May. The Commission is open and flexibility towards new ideas, suggestions and recommendations. All interested parties involved are invited for constructive work to achieve a good compromise. The speaker expressed his hope that it will be adopted before summer.

Ieke van den Burg of the EP focused on the opinion that has been adopted by a vast majority in the Employment and Social Affairs Committee of the Parliament last month (20 February 2003).

Currently, there is more attention and importance attached to takeover regulation in the Parliament. Moreover, more nation states are brought to alarm. However, three major objections raised by the Parliament in July 2001 were and still remain dominant concerns: i) the board neutrality principle, ii) considerations of employee interests, iii) level playing field vis-à-vis the US.

In the late 90's, the original objectives of transparency and minority protection procedures have been overruled by an ideologically controversial drive of establishing a dynamic market of corporate control and disciplining corporate directors. The reality of dynamic market for corporate control is manifested in long-term disastrous effects of extreme merger and acquisition activity both for companies, employees and shareholders.

The board neutrality principle is the most fundamental and controversial issue of the new proposal coupled with inadequate considerations for employee interests. Dogmatic pursuit of shareholder value maximization, though proved unrealistic, is fully present in the new proposal. However, it is not to be found as a clear objective of the new proposal. Under this light, the board neutrality and break-through rules should be evaluated separately in ensuring a level playing field.

In the Dutch context the shareholders own shares and ownership does not automatically trigger control. The control and decision making power rests with the management board of the company which enables the company to take into consideration a broader spectrum of stakeholder interests rather than prioritizing on the interests of shareholders. The Dutch context also takes a wider consideration of interests of employees and work councils.

Overall, the board should be given a power to decide on takeovers. The board neutrality principle should be abandoned because "That's the world upside down!" Employee interests should be taken into account.

Luc Renneboog and Joe McCahery presented the "The Economics of the Proposed European Takeover Directive", a Report sponsored by Standard & Poors and the European Round-Table of Industrialists (ERT).[1] The report investigates the extent to which country-specific corporate governance regulation, transparency and the quality of accounting information have an impact on the takeover market as reflected in the premiums paid for takeover targets and in the share prices of bidder and target firms. The bidding firm is willing to pay more when there is a high degree of transparency for the target firm, as reflected in better accounting standards and in a simple shareholder structure. As such, bidding firms value the application of the one-share-one-vote principle in the target firms as complex ownership structures based on shareholder pyramids obscure the control power in the target firm and as multiple class shares hinder the acquisition of the target. The report also finds that the bidding firms are willing to pay higher premiums when the protection mechanism exists to protect minority shareholders of the bidder.

According to the Report, the level playing field concept, introduced by the High Level Group, remains vague and capable of causing conflicting interpretations. In so far as the break-through rule might frustrate contractual promises between shareholders and the firm, and reduce the value of target firm's shares in the presence of agency costs, the Report argues there is a strong case that board neutrality and the breakthrough rule should be assessed on their own merits as necessary and sufficient conditions to create a level playing field for takeover bids.

The Report suggests that the break-through rule violates the principle of shareholder democracy and decision-making and is capable of reducing the value of the target firm and its economic efficiency. There is also a logical inconsistency between the aims of the mandatory bid and the break-through rules. Overall,

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[1] Mc Cahery, Joe and Renneboog, Luc (2003). *The Economics of the Proposed European Takeover Directive*. CEPS: Brussels (forthcoming).

For a full transcript of PowerPoint-presentations, please contact Isabelle Tenaerts at itenaerts@ceps.be

the Report recommends that the break-through rule is a costly and inefficient mechanism to support the development of a level playing field.

In so far as board neutrality entitles shareholders with better information, high-powered incentives to value the bid, and safeguards them against the opportunistic behavior of incumbent management, the Report argues in favor of it and claims that post bid defences should not be allowed. The Report suggests that when there is a choice between two alternative regulations: board neutrality vs. managerial veto, the EU should adopt the rule that is more favorable to outsider shareholders since it is more likely to be changed over time.

The Panel debate

The new proposal on takeover bids contains several positive elements, claimed **Stefano Micossi** of Assonime. For example, it has managed to take on board some of the European Parliament's concerns without eroding the fundamental principles of the proposed directive.

However, a number of objections can be raised. First, the directive – with its assumption that takeovers are welfare-enhancing – rests on an uncertain economic foundation. For example, there is no empirical evidence that the contestability of control increases the value of target companies by disciplining poor management.

More fundamentally, the proposal also raises legal issues. The aim of the directive is to achieve a level-playing field for takeovers within the EU by dismantling as many barriers as possible to the free circulation of shares and that may frustrate takeover bids. The removal of all such barriers, e.g. multiple voting rights, would however require "imposing limits to organizational and contractual freedom of private companies that most countries would not be willing to condone". This would run counter the content of Article 295 of the Treaty of the European Communities, which states that the Treaty "should in no way prejudice the rules in member states governing the system of property ownership". In any case, if addressing these issues, the takeover bids directive is not the proper vehicle, as it only deals with corporate rules in the event of a takeover. Instead, a more fundamental debate surrounding an EU-instrument on harmonizing corporate law is needed. Overall, the goal of a level-playing field appears "ill defined, contradictory and eventually counter-productive". An alternative approach could instead be to grant member states the ability in their transposition of the directive to allow shareholder meetings to delegate their decision-making to alternative bodies, such as the German supervisory boards. Naturally, such arrangements would have to be duly disclosed (Art 10 of the proposed directive).

It is with much concern that Swedish firms have followed the Commission's new thinking on the takeover bids directive, according to **Erik Belfrage** of Investor. Although not part of the Commission's proposal, it is clear that the Commissioner would like to include multiple-voting rights in the break-through principle, hence dismantling the major element of control in many Scandinavian corporate markets. The Scandinavian system is transparent, in fact more transparent than many European member states.

The existence and wide use of multiple voting rights have not precluded an active market for corporate control in Sweden. Indeed, large parts of corporate Sweden are now in the hand of foreign owners: Volvo Cars was bought by Ford, Pharmacia merged with Upjohn and Saab Automobile is now an integral part of General Motors. Overall, the foreign presence in the Swedish market is overwhelming.

As the system of multiple voting rights does not have a discriminatory effect, it is difficult to understand where the Commission would find the legal basis for effectively prohibiting it. If it persists in its desire of including it in the takeover bids directive, the Commission would open the door for legal challenges, first in member state courts, but ultimately in the European Court of Justice (ECJ).

The starting point for Standard & Poors when assessing the quality of a particular country's corporate governance legislation, claimed **Nick Bradley**, is transparency. Takeover legislation is of course important, but is not the main focus of our attention. Of more importance are shareholder rights overall.

The one-share one-vote regime is an ideal to strive for. However, 'substance' is more important than 'form' and the freedom of contract as mentioned before should be taken into consideration when evaluating multiple voting rights. . If there is a pre-agreement between issuers and shareholders to divide voting powers in any particular way, such an agreement cannot be reneged upon later.

In summary, S&P looks at best practice. Takeover legislation, the quality of which is difficult to measure, is generally not of primary importance in the overall assessment of a company's corporate governance practices unless these practices clearly disadvantage certain groups of shareholders e.g. minorities. The focus is instead on transparency, shareholder rights in general and the role of the board of directors (who guards the guards?).

The key in the takeover debate, according to **Wim Philippa**, is the competitiveness of the EU vis-à-vis its main trading partners. If, as envisaged by the Lisbon process, the US is going to be the main benchmark against which the EU's competitiveness is to be judged, then is important that the EU's stakeholders (public authorities, private actors) agree upon a common position during the current legislature (European Parliament & Commission).

Issues raised in the ensuing debate:

- The Commission should not strive to dismantle the arrangements in question (e.g. multiple voting rights). Instead, the transparency prescribed by the directive should suffice in the sense that shareholders would be fully aware of their rights and obligations. On over-zealous approach to inclusion (as exemplified by the European Parliament's rapporteur Mr Lehne) would be harmful (Micossi).
- As the proposal stands now, an exit of European companies from European markets is unlikely. However, if the directive was extended to cover e.g. multiple voting rights, the consequences may well be different (Belfrage).
- Legislation should only be a last resort. Instead, market pressure should be relied upon as far as possible. For example, companies with unattractive share schemes are likely to pay the price in terms of a suffering share price (Bradley).
- There is a need for some sort of common framework of takeover rules. If not, shares would circulate in markets where rules are entirely different. That situation would be opaque and distortive. Hence, there is a need for a minimum of common rules. However, the takeover bids directive is not the instrument to decide the pace of restructuring of European economies. If the directive's aim of achieving a perfect level playing field is achieved, the directive would effectively enter unchartered ground. Instead it is up to the markets to decide where to put its money, and hence set the pace of restructuring (Micossi).
- The large parts of the Commission proposal are balanced and well written. It contains room for two tier arrangements. If a company does not want to be contested, let that be so, the market will price accordingly. Such arrangements should remain for companies to decide, but any arrangement should be transparent so that the market is informed (Micossi).
- The takeover directive should refrain from entering into social considerations. It is important the economic primates prevail (Philippa).
- If multiple voting rights were included and it was decided that compensation should be paid to the holders of previously privileged shares, it would be difficult to agree on a correct level of that compensation. The control premium has sometimes been estimated at 15 per cent. However, this premium differs significantly between countries (e.g. Austria 38%, Netherlands 2%, Sweden 7% and the US 1%) (Renneboog).
- If some countries decide not to pay compensation there would indeed be no level playing field. However, the level playing field concept is misguided and should not be a benchmark for regulatory action. What matters overall is the overall competitiveness of corporate governance law, not compensation arrangements. Moreover, transparency is important in order to make this regulatory competition effective. So, each member state should try to come up with the best legislation possible (Mc Cahery).