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An American Perspective on the New German Anti-takeover Law

Law Working Paper N° 002/2002
February 2003

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Abstract

The new German Takeover Act contains antitakeover provisions that reject the "board neutrality/shareholder choice" of the rejected draft of the 13th Directive. These antitakeover provisions may have a particular (albeit temporary) justification as part of negotiating strategy to obtain a Directive with a "level playing field" approach to a wide variety of control barriers in the EU. This is because assent to cross-border mergers and the transnational economic integration associated with such mergers ultimately depends upon the control of economic nationalism. Mutual vulnerability to takeover bids by both acquirors and targets ? in which acquirors who engage in value-reducing home country bias would face a control threat ? can play a valuable role in restraining economic nationalism. Nevertheless, the German antitakeover provisions would have much more adverse impact than the US counterparts to which they are frequently compared. First, the favored US defensive measure, the poison pill, is not available under prevailing German principles of preemptive rights and nondiscrimination against any shareholder. German firms are likely to substitute irreversible, valuedecreasing measures that were replaced in the US by the pill, such as capital structure changes or asset dispositions. Second, the typical US practice of annual shareholder elections of board members combined with heavy institutional investor ownership in large public firms means that managements are highly sensitive to public shareholder interests in considering a takeover bid. By contrast, German supervisory boards turn over much more slowly, and are co-determined. German management feels less legal and cultural pressure to adhere to public shareholder interests. Third, stock option-laden compensation packages make US managers highly receptive to premium bids, especially because a takeover typically triggers the accelerated vesting of such options. German compensation arrangements do not now and, as a matter of culturally constraint, are unlikely to imitate the US version. So if Germany insists too hard on a 13th Directive to its exact taste, it risks sacrificing internal and cross-border mergers that would produce efficiency gains and aid the EU transnational project. _____

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ABSTRACT

The new German Takeover Act contains antitakeover provisions that reject the "board neutrality/shareholder choice" of the rejected draft of the 13th Directive. These antitakeover provisions may have a particular (albeit temporary) justification as part of negotiating strategy to obtain a Directive with a "level playing field" approach to a wide variety of control barriers in the EU. This is because assent to cross-border mergers and the transnational economic integration associated with such mergers ultimately depends upon the control of economic nationalism. Mutual vulnerability to takeover bids by both acquirors and targets – in which acquirors who engage in value-reducing home country bias would face a control threat – can play a valuable role in restraining economic nationalism.

Nevertheless, the German antitakeover provisions would have much more adverse impact than the US counterparts to which they are frequently compared. First, the favored US defensive measure, the poison pill, is not available under prevailing German principles of preemptive rights and non-discrimination against any shareholder. German firms are likely to substitute irreversible, value-decreasing measures that were replaced in the US by the pill, such as capital structure changes or asset dispositions. Second, the typical US practice of annual shareholder elections of board members combined with heavy institutional investor ownership in large public firms means that managements are highly sensitive to public shareholder interests in considering a takeover bid. By contrast, German supervisory boards turn over much more slowly, and are co-determined. German management feels less legal and cultural pressure to adhere to public shareholder interests. Third, stock option-laden compensation packages make US managers highly receptive to premium bids, especially because a takeover typically triggers the accelerated vesting of such options. German compensation arrangements do not now and, as a matter of culturally constraint, are unlikely to imitate the US version. So if Germany insists too hard on a 13th Directive to its exact taste, it risks sacrificing internal and cross-border mergers that would produce efficiency gains and aid the EU transnational project.

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The hostile takeover bid is likely to become an increasingly important influence on the German corporate environment. Hostile takeover bids unsettle not only the managements of the particular targets but also the economic and political milieu because of their disruptive challenge to well-established business patterns. From a German perspective, Krupp's unsuccessful bid for Thyssen and Vodafone successful bid's for Mannesmann have been signature event in defining the corporate governance landscape. The goal of this paper is to provide an American perspective on the German response, the rejection of the "board neutrality/shareholder choice" that characterized the EU's proposed 13th Company Law Directive and, instead, adoption of a German takeover law that seems to license target board defensive measures.

A surprising fact about the land of wild west capitalism is that hostile bids in the United States have been a relatively rare phenomenon for over a decade, only a few few dozen annually among the many hundreds, even thousands, of friendly deals, a consistent pattern throughout the merger boom years of the 1990s.[1] Nevertheless the effect of hostile bids is still very important, because many so-called friendly deals are negotiated against a backdrop of the hostile bid possibilities. Some would even say that the only real difference between "hostile" and "friendly" deals is the point at which the transaction becomes public.[2] Insofar as the merger waves of the 1980s and 1990s have played a positive role in the reshaping of American business,

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[1] On a broad definition of "hostile," there were an average of 40 hostile deals a year over the period 1994-1998, many fewer earlier in the decade. Even in the really rambunctious 1980s, the era of the financial buyer, the maximum number of hostile bids in any given year was less than 100, against many hundreds of friendly bids. John C. Coates, Measuring the Domain of Mediating Hierarchy: How Contestable Are US Public Corporations?, 24 J. Corp. L. 837, 856 (1999). On a narrower definition of "hostile," where the target rejects not only the first bid but subsequent bids, there were many fewer hostile deals, typically well under a dozen. Joseph H. Flom, Mergers and Acquisitions: The Decade in Review 54 U. Miami L. Rev. 754, 761 (2000). Even bids that start "hostile" usually end up "friendly."

[2] G. William Schwert, Hostility in Takeovers: In the Eye of the Beholder? 55 J. Finance 2599 (2000).

in enhancing the competitive focus of American companies, the hostile bid has played an important role, perhaps an essential role.[3]

Our text is the German anti-takeover law adopted in late 2001,[4] particularly section 33(1), which in adopted form allows management to take defensive measures merely upon approval of the supervisory board, without first going to shareholders for prior approval.[5] In other words, the German anti-takeover law has rejected the "board neutrality"/ "shareholder choice" position of the ill-fated 13th Company Law Directive, which, like the UK City Code, would have forbidden board action that would tend to "frustrate" a takeover bid.[6] Instead, management may, with board approval, have significant discretion to resist a hostile bidder. This opens a new era in the response of a German company to a hostile bid.

First I want to trace the history of this provision, at least a seen by an American observer, but then, more importantly, try to argue why the German anti-takeover law may have more negative consequences on mergers and acquisitions in Germany and the European Union than comparable laws in the United States. My theme will be that institutions matter and that culture matters, and that the institutional and cultural factors that disarm high-powered anti-takeover devices in the US like the poison pill may not operate in Germany.

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[3] See generally Jeffrey N. Gordon, The Shaping Force of Corporate Law in the New Economic Order, 31 U. Richmond L. Rev. 1472 (1997).

[4] The Act is formally cited as "Wertpapiererwerbs- und Übernahmegesetz" v. 20 Dezember 2001 (BGBl. I. S. 3822). A useful summary of its provisions are found in the Int'l Fin. L. Rev. (March 2002). A more extensive, very useful account, including a legislative history, is provided by Gabriele Apfelbacher et al, German Takeover Law – A Commentary (2002).

To be sure, the Act is more than an "anti-takeover law." It regulates all aspects of public bids in Germany, and insofar as it establishes clear rules and procedures and brings some useful innovations to German corporate law such as the freezeout merger, it may aid the making of offers for German firms, including hostile offers. Nevertheless its distinctive feature, the subject of extended debate during the legislative process, is the anti-takeover element.

[5] Sec. 33(1) reads: "After announcement of a decision to make an offer, up to the publication of the results of the offer, the management board may take no actions that could frustrate the offer. This does not apply [to certain action] ... *as well as for actions which have been approved by the target's supervisory board*." (Thaeter & Frederick transl.)(emphasis added).

[6] Section of the July 2000 draft of 13th Directive provided in relevant part:

> "during the period [beginning when the offer is publicly noticed and ending when the results are announced or the bid is withdrawn] the board of the offeree company shall obtain the prior authorisation of the general meeting of the shareholders, given for this purpose, before taking any action which may result in the frustration of the bid, other than seeking alternative bids, and notably before the issuing of shares which may result in a lasting impediment for the offeror obtaining control of the offeree company."

For the Council text and the proposed amendments of the European Parliament, see European Parliament, Recommendation for Second Reading, 8129/1/200 - C5-0327/2000-1995/0341 (COD).

Mergers serve two general objectives for Germany. The first relates to the traditional purposes of industrial organization: to achieve optimal size and scope for business operations, to reconfigure business units into better structures with vertical and horizontal efficiencies, to permit useful consolidation where there is overcapacity, and on some occasions, to replace one managerial team with one that may perform better. In these purposes mergers in Germany have much in common with those in the US.

But Germany is also part of the transnational project that is the European Union, and thus cross-border mergers serve a distinctive and especially important objective. Only through cross-border mergers can enterprises rapidly grow large enough to take advantage of the huge potential scale economies of EU-wide commerce. One of the great advantages of the US is its internal common market, which gives national businesses the immediate opportunity to move along the experience curve towards the lowest per unit output costs. This internal market is not only a substantial engine of local prosperity but makes those firms formidable competitors in international trade. The creation of EU-wide firms offers Europe similar potential.

But apart from efficient scale, cross-border mergers rapidly build businesses that are conduits for the transnational free flow of capital, good, services, and people, and, no less, a transnational attitude. Cross-border mergers are important for Germany and the EU generally, because the business organizations that result, trans-European firms, help bind the EU into a single economic entity and thereby serve the project of transnational economic and political integration. The creation of economic and monetary union lays the groundwork for this powerful change, but cross-border mergers must play a very large role as well.

Nevertheless cross-border mergers entail a special sort of risk. The government of the state of the target's organization will be legitimately concerned that investment and divestment decisions will be influenced by economic nationalism benefitting the state of the acquiror's organization. Will the acquiror show home country bias in either facilities location decisions or in layoffs or downsizings? Another way to put the question: Will the minister insist that the new plant be located in Lyon rather than Düsseldorf?

What best protects against the potential for such economic nationalism is the mutual vulnerability to takeover bids by both of the firms in question. To see this, assume the acquiror begins to show significant home country bias. This inefficiency in the acquiror's operations will lead to a fall off in shareholder value that would create an opportunity for a control entrepreneur, if the acquiror was also exposed to the potential for a hostile bid. In other words, if firms in all countries are equally exposed to the threat of hostile takeover, this will help constrain the economic nationalism that is the greatest threat to the EU project while permitting very valuable cross-border merger activity.[7]

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[7] This is not to say that exposure to takeovers is a complete solution to the economic nationalism problem. A government could make payments or provide subsidies to cover the costs to the firm of economic nationalism and thus protect shareholder value. But such payments might be fiscally infeasible, they could be matched by a competing government, and, of course, such payments could be forbidden by the transnational regime. Takeover

With this argument in mind, I therefore have some sympathy for the articulated basis for German opposition to the 13th Directive's position on board neutrality, the problem of the "level playing field." The 13th Directive addressed only the particular barrier to a hostile bid rooted in the board's defensive response. But other, perhaps more significant barriers might be found in the underlying corporate law or in the local pattern of ownership structure (including state retention of special control rights through "golden shares"), or the distribution of voting rights.[8]

In the years that the 13th Directive was debated, Germany moved from a closed to a more open system of corporate control; many of its extra-board barriers came down. This took place through significant corporate law changes, for example, the end of capped voting and new limitations on bank exercise of customer proxies. Also important was a tax law change, the phase out in January 2002 of the capital gains tax on the sale of corporate shareholdings, that would eliminate the financial lock-in of corporate cross-shareholdings. There were also ownership structure changes that produced over the 1990s a significant increase in the number of firms with dispersed ownership without a large blockholder.[9]. Most importantly, there were cultural changes, reflected in the contrasting reactions to Pirelli's hostile bid for Continental in 1991 vs. the Vodafone hostile bid for Mannesmann in 1999. Germany had opened itself to the market for corporate control to a much greater extent than its EU partners, except for the UK, and, not unreasonably in my view, was concerned about potential harms from economic nationalism potentiated by an incompletely liberalized cross-border merger regime. Yes, undoubtedly there were concerns -- some legitimate, many overblown – on the part of managers and employees about the adjustment costs of economic change that also motivate anti-takeover legislation in the US. But I would like to think that the crucial element in the German coalition against the 13th Directive and for section 33(1) of the new German anti-takeover law consisted of those who would see Germany's tougher position as a bargaining chip in a kind of trade negotiation, a raising of barriers designed to precipitate a crisis and force a new round of negotiations that would lower trade barriers – here, takeover protections – across the board.

So I commend that work of the Committee of Experts, the Winter Commission, that reported in January 2002 with a charted course towards a revised 13th Directive. Its crucial move

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vulnerability makes it harder for a government to promote economic nationalism simply by imposing the costs on shareholders. (Note that the temptations of this approach are increasing in the percentage of foreign stock ownership and that stock-for-stock cross border mergers will almost certainly increase the percentage of initial foreign ownership.)

[8] As will become clear below, I think the level-playing- field argument, which may have force for the EU, does not work for the US, where control is quite contestable notwithstanding legally permitted defensive measures.

[9] In 1991 approximately 10 percent of German publicly traded firms were either widely-held or had no large (25 percent or more) blockholder. Tim Jenkinson & Alexander Ljungvist, The Role of Hostile Stakes in German Corporate Governance, 7 J. Corp. Finance 397, 405 (2001). By 1999 the corresponding percentage was 25 percent. See Christoph Van der Elst, The Equity Markets, Ownership Structures and Control: Towards and International Harmonisation? forthcoming in E. Wymeersch (ed.), Company Law and Financial Markets (2002).

is to call for the overcoming of "golden share" and most other national barriers to a control transfer through a novel "breakthrough" provision that lets a holder of a majority (or a required supermajority but in no event more than 75 percent) of cash flow rights succeed in a takeover bid. If implemented such a rule would substantially allay the level playing field concerns that assumed a significant role in the shape of Germany's new anti-takeover law. The prospects for such a rule should have received a boost from the June 2002 decisions of the European Court of Justice, which suspiciously viewed golden shares as presumptively restricting the free movement of capital and therefore required the showing of precisely tailored scheme for the national interest to be protected.[10] In particular the ECJ rejected a golden share retained by France in Elf-Acquitaine that permitted the Minister virtually unbounded discretion to block any significant accumulation in the company's shares. The Court has strengthened the Commission's hand.

The second part of my argument is to explain why the German anti-takeover law will have far more adverse consequences than its US counterparts. A popular defense/apologia for the German law is a variant on the level-playing-field argument: US corporations are protected by such laws, so German firms need similar protection, and then a harmonization-type argument: if target defensive tactics work out, all things considered, in the US, then they should work for Germany. These arguments rest on a faulty factual premise: that defensive measures really protect US firms from hostile bids. They do not. Generally speaking, they merely structure a process in which the target board can negotiate a higher price for the shareholders. But that fortunate outcome is the result of institutions and practices that may not be easy to reproduce in Germany. The same basic legal rules may lead to a radically different outcome in Germany.

Here are three examples. First, the favored US defensive measure, the so-called flip-in poison pill, will not be available to German managers, who will instead use value-reducing defensive measures. The flip-in pill operates by penalizing an unwanted acquiror that crosses an ownership threshold, say 15 percent, by giving the *other* shareholders the right to purchase target shares at a bargain price. To give an example based on the standard US pill: assume the target has 100 shares of stock outstanding. Then if a bidder were to acquire more than 15 shares, the remaining shareholders would have the right to acquire (from a stock issuance by the target) an additional 85 shares at a price equal to 50 percent of the bidder's per share acquisition price. In other words, the flip-in pill operates through a discriminatory issuance of cheap shares that would drastically dilute the hostile bidder's stake. This is such a potent weapon that no poison pill has ever been triggered.[11]

It appears that a poison pill would not be feasible under German corporate law because

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[10] See Commission v. France, C-483/99 (June 4, 2002); Commission v. Portugal, C-367/98 (June 4, 2002); Commission v. Belgium, C-503/99 (June 4, 2002).

[11] It may be worth noting that the US "poison pill" is structured under of the law of the state of incorporation of a US corporation and that the particular features may vary by state. There is no "federal corporation law" in the US, in part because of important US Supreme Court cases that have in important ways confined some potentially expansive provisions of the US securities law to disclosure problems rather than substantive conduct or fiduciary duty.

its discriminatory feature would violate strong mandates for preemptive rights.[12] If so, German anti-takeover measures will resemble those used in the US in the 1970s and early 1980s: for example, defensive acquisitions to create competition policy problems for the acquiror, setting up a blocking position for a "white knight" through a sweetheart sale of securities; selling off assets that an acquiror might prize, the "crown jewels"; reshaping the capital structure, as through additional leverage, to make the target less desirable; creating so-called "tin parachute" agreements that promise large bonus payments to rank and file employees upon a control shift; exotic tactical moves, such as the so-called "Pac-Man" defense of responding to a hostile bid with a counterbid for the putative acquiror. Unlike the pill, which can be redeemed by the board to permit a bid proceed, these tactics are often irreversible. They reduce value; they disrupt the economic logic of the firm; they can destroy the firm in order to save it. Such self-destructive measures are now used by virtually no firm in the US, but they may be inevitable in light of other features of German corporate law.[13]

Second, the typical US practice of annual shareholder elections of board members combined with heavy institutional investor ownership in large public firms means that managements are highly sensitive to public shareholder interests in considering a takeover bid. Management's understanding, a product of law and acculturation, that the firm is to be run for the shareholders, means that many bids, even if initially unwelcome, become friendly rather than hostile. Compare Germany. The two-tier board structure under co-determination already reduces shareholder influence. There is greater emphasis on stakeholder concerns. No less important is the five year term for supervisory board members, which attenuates the board's sense of accountability to shareholders. Yes, under German law a 75 percent holder can remove and replace supervisory board members,[14] but observe how hard it can be to assemble 75 percent in a proxy contest for control and by, contrast, how easy it is to assemble a blocking coalition. So the German board structure and electoral pattern predicts for a more resistant use of defensive

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[12] German law requires a 75 percent vote for the limitation of preemptive rights, AktG § 186(4), and requires an explicit written explanation before the shareholder vote. A poison pill has never been put to shareholder vote in the US principally on the belief that the shareholders would reject it. Moreover, since the shares will be issued conditionally, a flip-in pill would be subject to additional, more limiting requirements for conditional increases in capital, AktG § 192.

[13] Some might argue that existing German cases and statutes would limit management flexibility to act without shareholder approval. For example, the *Holzmüller* doctrine [BGHZ 83, 122 et seq.] requires the Management board to obtain shareholder approval for a transfer of substantial assets. Moreover, the duty of conscientiousness and prudence required for Management board and the Supervisory Board decisions, AktG §§ 93, 116, may lead parties concerned about personal liability to seek shareholder approval for defensive measures. Nevertheless the courts may well decide to give broad scope to the legislative delegation of authority in [Takeover Act] § 33(1) to the Management and Supervisory Boards to act unilaterally in the face of a hostile bid. In any event the courts are likely to employ a form of "business judgment rule " review, which in the US has meant a great deal of deference to board decisions taken in good faith after a reasonable process of investigation and deliberation. Boards may be reluctant to seek shareholder approval, either "reserve authorization" within eighteen months of the offer, much less authorization after the offer, out of concern that shareholders will refuse and will thereby make subsequent unilateral management actions harder to justify.

[14] AktG §103.

options in the face of a hostile bid.

Third, in the US the managers' tendency to resist a takeover bid for self-interested reasons has been substantially curbed by a compensation structure that may be legally permitted in Germany but is likely to run afoul of strong cultural constraints on managerial compensation. US managers, especially the chief executive officer, receive a large percentage of their compensation in stock options. If the stock price significantly appreciates, the managers receive a correspondingly large payout. If used correctly, this can be a very useful incentive alignment mechanism with shareholder interests.[15] These stock option grants are typically structured to vest over time, a 10 year period, say, to cover the managers' tenure with the firm. However, upon a transfer of control, the vesting of the options will accelerate; they vest all at once, and so the CEO of a target not only does well but can become genuinely rich. Why resist a takeover bid that is not only value increasing for the shareholders but also delivers a great payday for yourself and your management team? This helps explain why there are so many takeover bids in the US but few hostile bids.

Ask yourself if this is a feasible strategy for Germany. Let us note in passing the case of Kurt Esser of Vodafone, who delivered tens of billions of extra euros for the shareholder of Mannesmann through his negotiating strategy and his determination to let the shareholders decide, and who nevertheless was severely criticized – almost prosecuted – for his receipt of a €15 million bonus. If the reshaping of executive compensation with grants of lucrative stock options to counteract management's new authority to protect power and perquisites is not possible, then the German anti-takeover law will be a significant barrier to good deals as well as bad ones.

The difficulty in reshaping executive compensation has recently been deepened by the recent European Commission decision to require all firms listed on a European stock exchange to adopt International Accounting Standards within the next five years.[16] Unlike US GAAP, IAS requires the expensing of executive stock options. If the US executives who fought so hard against reform proposals in the early 1990s to require expensing are correct, then the IAS rule will independently stifle large stock option grants for European managers. In other words, the impact on reported earnings of large option grants may suppress their use independent of cultural factors. But the consequence will be a significant difference in management's incentives in the face of a hostile bid as compared with the US paradigm.

So there is a dilemma here: if Germany can use the barriers of the new law to jumpstart a renegotiation of the 13th Directive towards a more level playing field, towards a more completely

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[15] As recent cases, such as Enron, in the US demonstrate, it is also possible to add so many stock options as to drive managers to prefer risks that shareholders would not countenance. See Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U.Chi. L. Rev. 1233 (2002).

[16] v. 13.02.2002, COM (2001) 80 endg. 2001/0044 (COD).

liberalized cross-border mergers and acquisition regime, this will, I predict, advance the causes of European union and German economic prosperity. But if the 13th Directive project is beyond recovery, then the new German anti-takeover law is potentially very damaging for both those enterprises. Without a credible threat of a hostile bid, many fewer mergers will take place, and such mergers, especially cross-border mergers that achieve transnational scale, may be the key to greater economic competitiveness and to the EU project of economic and political integration that has stirred the hopes of the world.

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