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# Reciprocity in Takeovers

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## Abstract

The European Commission has proposed a Takeover Directive that aims to make the control of European corporations more contestable. The European Parliament and Germany will not adopt the Directive unless it provides for reciprocity in takeovers, limiting access to the articles of contestability to bidders that have adopted contestability themselves. Reciprocity in takeovers is not desirable. It unduly restricts the pool of bidders and reduces the potential benefits of contestable control. Contestable control itself has benefits, but the theoretical and empirical support for neutralising the power of incumbent blockholders and boards is too weak to justify large-scale regulatory intervention. The most powerful instruments for making corporate control contestable are not available in all Member States. The Takeover Directive could put these tools on the menu throughout the European Union, allowing companies that want them to embrace them – and giving institutional investors a chance to push for the hug. The current proposals will not change much, one-way or the other. If anything, they will add another level of complexity and confusion to the prevailing systems of corporate control in Europe.

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Keywords: European takeover directive, break-through rule, reciprocity in takeovers, ownership structure, takeover defenses, voting rights, contestability of corporate control

JEL Classifications: G34, G38, K22

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## 1 Introduction[1]

After more than ten years of consultations, revisions and negotiation over related and unrelated issues[2] observers were confident that the European Parliament would adopt the European Commission's proposal for a Takeover Directive in the second round of its second reading. Like the first draft, the new proposal was closely modelled on the UK's City Code, but took into account concerns over employee involvement, "tactical" litigation (greenmail) and the proper role of Member States (subsidiarity), among others.[3]

In the Commission's view a European Directive on takeovers was needed for facilitating corporate restructuring by having common rules and procedures applying to the takeover process throughout the single market and by providing equivalent protection for minority shareholders in takeover situations.

The proposed Directive had three essential features: one, a mandatory bid rule designed to protect minority shareholders; two, a squeeze-out provision allowing bidders to "go private" after a successful bid; three, a board neutrality rule, putting the bid quickly to the target shareholders without giving the board a chance to bargain with the bidder, or to frustrate the bid. The mandatory bid rule effectively eliminated sales of control through partial share block trades; the board neutrality rule effectively banned post-bid takeover defences.

The draft adopted by Member States on 19 June 2000 seemed uncontroversial. Couched as a "framework" (compromise) Directive, it gave Member States considerable freedom for implementing the mandatory bid rule. Indeed, some observers criticised the proposal for being too flexible, thereby undermining its objectives. Furthermore, while waiting, many Member States had already adopted national takeover legislation that exceeded the stipulations of the draft Directive, legislation that was successfully tested by the largest (hostile) deals in European history.[4] Final adoption of the compromise Directive by the European Parliament and the Council of Ministers appeared a foregone conclusion.[5]

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[1] There are numerous articles, comments and presentations that have commented on various aspects of the proposed Takeover Directive at various stages of its development, for example Berglöf and Burkart (2003), Burkart and Panunzi (2003), Coates (2003), Franks (2003), Mülbert (2003), McCahery, Renneboog, Ritter and Haller (2003), Dauner Lieb and Lamandini (2002), Bolton (2002), Pagano (2002), Jensen (2002) and Bebchuk and Hart (2002). I will concentrate on contestability and reciprocity.

[2] At some stage Spain sought to "trade" concessions on the Takeover Directive against concessions on to the future of Gibraltar.

[3] The initial proposal for a "Thirteenth Council Directive on Company Law Concerning Takeover Bids" was published on 19 January 1989 (COM(88)823 final – SYN 0186). It was followed by an opinion of the Economic and Social Committee (27 September 1989), an opinion of the European Parliament (17 January 1990) and an amended Commission proposal (COM(90) 416 final – SYN 0186). A second proposal was presented to the Council and Parliament on 8 February 1996 (COM(95)655 final), followed by an opinion of the Economic and Social Committee (11 July 1996) and a first reading of Parliament (26 June 1997), that resulted in twenty proposed amendments. The Commission's revised draft of the second proposal was retransmitted to Council and Parliament on 11 November 1997. At the same time the Commission published "frequently asked questions", that tackled the concerns that had been raised in plain language (http://europa.eu.int/comm/internal_market/en/company/company/news/takeoverfaq.htm). For links to the full text documents see http://www.ecgi.org/takeovers.

[4] The hostile bid of Olivetti for Telecom Italia during 1998/99 was driven by Italy's privatization law. It is an important case because it was – to my knowledge – the first application of a "breakthrough rule".

[5] Indeed, the Council adopted, unanimously, a common position (19 June 2000) that was accepted by the European Commission (26 July 2000).

To the European Commission's surprise, it transpired that a German led group of Members of the European Parliament were not satisfied with its proposal. The MEPs demanded "reciprocity in takeovers", or allowing post-bid defences. It was unfair, so they argued, that some countries were depriving their corporations of all takeover protections while others were not, allowing their corporations to go on hostile acquisition sprees in the neighbours' gardens wearing a bullet proof vest.

Germany formally joined the rebel MEPs position and it became apparent that the original move was motivated by a political inconsistency : The German "Control and Transparency Law" (KonTraG) had just banned most pre-bid defences and led, indirectly, to the successful hostile bid of Vodafone plc for Mannesmann AG, the target not having bothered to replace its expiring pre-bid defences with a potent alternative.[6] Alerted to its vulnerability, the widely-held chemical industry (and others) extracted a promise for post-bid defences from Berlin, that Brussels was about to ban.[7] Put to a vote in the Parliament, the European Commission's proposal fell short of the required majority by one vote. The Parliament sent a message that without reciprocity in takeovers, also with companies from outside the EU, the proposed Directive would not pass.[8]

As a response to the impasse, the European Commission invited a "high-level group of company law experts" chaired by Jaap Winter (the Winter Group) to suggest a technical solution to the reciprocity in takeovers challenge. The response of the Group is the so called "breakthrough rule". Inspired by the Italian privatisation law and a recommendation of the French Commission des Opérations de Bourse (COB), the breakthrough rule stipulates that a bidder acquiring 75% of the "capital at risk" in a target can break through all statutory takeover defences.[9] Although the Winter Group proposals did not introduce full reciprocity, the "breakthrough rule" made certain existing defences less effective, in particular pre-bid defences based on dual-class shares.

After intensive lobbying from Member States and companies with dual class share structures, the follow-up proposal of the European Commission did not adopt the full breakthrough rule (COM (2002) 534 final).[10] However, the report of the European Parliament's rapporteur

[6] Mannesmann had in place a voting right restriction of 5% that was due to expire a few months after the Vodafone bid was launched. When coupled with proxy vote support from German banks, voting right restrictions have traditionally provided a formidable takeover protection in Germany (Franks and Mayer 1998). Without the voting right restriction, a rising proportion of votes in the hands of international investment funds and strategic change at the helm of Germany's large there was not much choice but to raise the white flag.

[7] For further details on the German takeover law see Gordon (2002).

[8] Reciprocity in takeovers (a "level playing field") was only one of four issues the Parliament felt needed to be resolved, but the other three were less political and could be more easily resolved at a technical level: a procedure for a "squeeze-out right"; a definition of the equitable price to be paid in the case of a mandatory bid; clarification of the rights of employees.

[9] The Group also recommended to ban share transfer restrictions and recommended the application of the breakthrough to "golden shares". It also recommended further study of pyramid structures, cross-holdings, circular shareholdings and the implications of imposing reciprocity on companies from outside the EU under international trade law principles and agreements. See Winter Group (2002).

[10] The main arguments put forward were several legal problems and one economic consideration. Legal problems were : finding a definition of risk-bearing capital, the threshold for triggering the break-through; the dilution of the rights of ordinary shareholders from giving non-voting shares votes, the suspension of multiple voting rights without compensation (and resulting constitutional problems from such expropriation), breach of freedom of contract and undue interference with Member States' company law. The sole economic consideration was the well documented theoretical insight that that dual class share structures actually make it cheaper to acquire control (stimulating the market for corporate control). See the Commission's "frequently asked questions" (MEMO/02/201, 02/10/2002).

(COM(2002) 534 – C5-0481/2002 – 2000/0240(COD), 11 March 2003) reinstated the original proposal. It imposed "one-share-one-vote" for the breakthrough rule[11] and the shareholder vote on post-bid defences[12], but granted an explicit breakthrough exemption to airlines[13], central banks[14] and IPO companies.[15] The report also introduced a new article on "international" and "intra-European" reciprocity.[16]

Not surprisingly, the European Parliament's proposal was unacceptable for countries with dual-class share structures and a permanent stalemate was in sight (again). In May 2003 the Portuguese Presidency tabled a compromise proposal.[17] It foresees a reciprocal breakthrough regime companies can opt into (Option A), or not (Option B). Companies in the "breakthrough club" allow other companies to use the breakthrough rule when making a hostile offer for acquiring their control. In return they can use the breakthrough rule when making bids for other companies in the club. Companies outside the club cannot use the breakthrough rule – but other companies cannot bid for them using the breakthrough rule either.

The latest report from the European Parliament has adopted the spirit of the Portuguese proposal.[18] Similarly, the Italian presidency has circulated a draft that allows Member States to opt-out of board neutrality (Article 9) and/or the breakthrough rule (Article 11), but it also allows companies in Member States that have opted-out to opt-in. Reciprocity is limited to board neutrality (Article 9), provided the target company has opted-in.

The remainder of this chapter is structured as follows: Section 2 provides a stylised map of corporate control arrangements in Europe. Section 3 argues that reciprocity in takeovers requires more radical measures than those proposed at the moment. Section 4 questions whether "reciprocity in takeovers" doctrine as a policy objective in its own right. Section 5 concludes.

## 2 Models of Corporate Control[19]

The economics and finance literature distinguishes two basic models of corporate control and governance: the **blockholder model** (**B**) and the **widely held** corporation **model** (**W**). In the blockholder model an individual, a group of individuals or an organisation command many (most) of the votes at the corporation's shareholder meetings. The blockholder has the power

[11] Amendment 29 (Article 11, Paragraph 4)
[12] Amendment 28 (Article 11, Paragraph 3a (new))
[13] Airlines must be able to show that they are majority owned and/or controlled by the nationals of the member state in which they are registered, otherwise they can loose their landing rights outside the EU, that are often guaranteed through bi-lateral aviation agreements (Amendment 27).
[14] The Belgian Central Bank happens to be a listed company (Amendment 13, Article 1, paragraph 3 (new)).
[15] IPO companies are exempted from the breakthrough rule for up to five years (Amendment 30).
[16] A new Article 17a gives Member States the possibility of blocking bids from outside the EU, if "important interests so require" and international legislation is respected (Amendment 36). Article 17b allows Member States to block bids from bidders deriving the bulk of their turnover from state guaranteed monopoly activity (Amendment 37). This amendment is motivated by Electricité de France's cross-border acquisition programme that is considered as unfair by some Member States, for example Italy, that has chosen to make the control of its privatized companies to contestable (see Section 3.1).
[17] A revised Directive incorporating the Portuguese proposals was presented at the beginning of June 2003.
[18] COM(2002) 534 – C5-0481/2002 – 2000/0240(COD), 3 September 2003, PE327.239/rev.
[19] For a more extensive treatment of corporate control issues see Becht and Mayer (2002); for a survey of takeover theory and evidence see Burkart (1999).

to appoint and/or remove the board of directors and the blockholder appointed board appoints and/or removes the CEO.[20] In contrast, the widely held corporation has a broad equity base with many small shareholders who, individually, command a small number of votes. The incumbent board nominates the new board, which is confirmed by the passive mass of small shareholders in a vote. Formally the board appoints the CEO. In practice, the CEO appoints the board, putting incumbent managers in control of the widely held corporation.

Empirically, most companies in Europe have a blockholder commanding at least a blocking minority of 25% (Figure 1) and often a majority of the voting rights (Figure 2). The United Kingdom is an exception. Here all but a few FTSE 100 companies have no blockholder larger than 100% (Figure 12).

### *2.1 Two Models - Four Flavours*

In practice, each of the main models comes with two flavours. In the blockholder model blocks of votes can be acquired with a proportional amount of capital ("one-share-one-vote"; Model **B1**) or with a less than proportional amount, through legal devices that give blockholders more than one vote for each Euro invested ("one-share-more-votes"; Model **B2**). Prominent examples are equity capitalisations with non-voting shares (Figure 3), shares with multiple voting rights (Figure 4) or issuance of certificates without votes (De Jong *et. al.* 2001). The most complex of these devices are "Chinese boxes", "pyramids" or "control cascades" that combine companies to control chains (Figure 5, Figure 6). At each level of the chain the controlling blockholder brings in outside capital while keeping control, thereby reducing the cost of control.[21]

For widely held companies we distinguish between those open to hostile takeovers (Model **W1**) and those that are not (Model **W2**).[22] In companies that are open to hostile bids, an outsider can purchase shares to form a controlling block, moving the company from the widely held to the blockholder model. The incumbent board (and/or CEO) is forced to hand control to the blockholder.

In well defended companies, share blocks cannot be assembled without board and/or CEO approval. In Europe, pre-bid defences in widely held companies include devices like voting right restrictions (Figure 7), share transfer restrictions (Figure 8) and shares vested with

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[20] In some countries the ability of blockholders to appoint, remove or influence boards is limited by company law (Germany, Holland) or listing rules (in the United Kingdom). In Belgium a blockholder commanding 50% of the votes (plus one vote) can remove the board at any time ("*ad nutum*"), bringing the Belgian system very close to our stylised description of the blockholder model.

[21] Empirically we do not know with precision how much voting power leverage B2-type blockholders derive from the various devices. Under European disclosure rules only voting rights, not cash-flow rights, are systematically disclosed throughout the European Union. Hence it is notoriously difficult to estimate how much leverage these instruments provide for blockholders across larger samples, at least outside of Scandinavia (Barca and Becht 2001). It is possible, of course, to look at capital structures. Expanding on Faccio and Lang (2002), Bennedsen and Nielsen (2002) have estimated that 1035 of 5162 listed firms in the EU (excluding Greece, Holland and Luxembourg) have dual class structures, with varying degree of importance in the firm's equity base. The disclosure situation for groups is even sketchier, making estimates of the control leverage in pyramidal structures even less reliable. Nevertheless, attempts have been made to estimate the extent to which the instrument is used. On the one hand they exaggerate the extent of pyramiding by counting complex holdings as a pyramid, on the other they might not be able to trace the full control chain (see, for example, Faccio and Lang (2002) for a recent empirical study, subject to the limitations of current disclosure rules).

[22] A least in theory, the "breakthrough rule" converts W2 into W1 companies by allowing bidders to overcome statutory takeover defences.

special rights (Figure 9). The most potent post-bid defence is "blank cheque" preferred stock that can be placed with white knights, squires or other friendly party (see Figure 10).

To make the field even more colourful, some companies have special control structures that mix flavours or that are not straightforward to classify. For example, widely held companies with statutory pre-bid defences (Model W2) face the problem of bidders acquiring a supermajority (75%, 66.66%), allowing them to change the statutes and to remove the protections.[23] In this situation, "lock-in" provisions are crucial. The simplest "lock-in" is a Model B1 or B2-style minority block of 25% (or 33.33%).[24] The most sophisticated version is a priority share construction (Figure 9).

Both flavours can be found in privatised companies. The B2-style blocking minority is found in the case of Volkswagen AG (Figure 11), which is still governed by a special privatisation law. The law provides for a 20% voting right restriction. The arrangement is locked in through a blocking minority held through a dual-class share capitalisation by the Land of *Niedersachsen*, where the VW headquarters and its main plant are located.[25] The priority share lock-in is known as a "golden share provision" in privatised companies.

More exotic are partnerships limited by shares that can be found in Germany (Henkel *KGaA*), France (Michelin *sociétés en commandite*) and Italy (Pirelli & C *Accomandita per Azioni*). The unlimited liability partners have full control over the company with a relatively small investment, with limited liability shareholders providing the bulk of the funds.[26]

## 3 Achieving Contestability with Reciprocity

To achieve reciprocity in takeovers the Takeover Directive will have to ensure that the control of takeover targets is contestable and that the group of bidders that have access to the tools that make control contestable is limited to companies with voting control that is equally contestable. To achieve this aim the bidder and the target must be widely held and have no statutory takeover protections. Alternatively, a breakthrough rule must allow bidders to overcome such protections – and vice-versa.

The proposal put forward by the Winter Group does not achieve full reciprocity. For widely held companies the Group proposes to shrink the menu of available statutory defences[27] and to apply a breakthrough rule that is conditional on 75% acceptances. The latter raises the cost of locking in statutory defences, but it does not allow bidders to overcome statutory defences that are secured through a minority block.[28] More importantly, the control of listed companies

[23] Indeed, this is the very mechanism the Winter Group baptised a "breakthrough rule".
[24] Under the original Winter Group proposal, only a Model B1-style block will provide the required "lock-in".
[25] Indeed, the Volkswagen law adds a further twist by raising the supermajority threshold to 80%, so only a smaller (cheaper) 20%, B2-style block is required for the lock-in.
[26] At least in the case of Michelin, the partnerships limited by shares as a corporate control structure is defended with great passion against the criticisms often voiced by institutional investors (see www.michelin.com).
[27] The Group proposes, for example, to ban share transfer restrictions.
[28] The attention of the media has focused on the proposed "one-share-one-vote" provision of the original breakthrough rule. This issue is important but is merely an extension of the more general observation. Dual-class share structures make it cheaper to put a 25.1% blocking minority in place, but there are close substitutes that are readily available. Companies that want to have "one-share-one-vote" blocking minorities more cheaply can use pyramiding (Bebchuk and Hart 2002) and/or a dual-class holding company incorporated, for example, in Switzerland where dual-class blocking minority *cum* statutory takeover protection instrument will still be available.

under majority control and the control of privately held companies remains incontestable, yet all these companies can continue to launch hostile bids on widely-held, open targets.

The Portuguese "breakthrough club" proposal appears more promising. It ensures that the Winter Group's proposals will only apply with reciprocity. To use the breakthrough rule as a bidder, the bidder has to subscribe to the breakthrough rule, making the bidder a potential target. The trouble is that subscribing to the breakthrough rule alone does not make the control of a bidder contestable. Blockholder controlled companies and companies with statutory takeover protections locked in by minority blocks will happily opt into the "breakthrough club". Even with a breakthrough rule, their voting control is not contestable. Hence, even when combined with the Portuguese "breakthrough club" proposal the breakthrough rule alone does not deliver full reciprocity in takeovers.

To make the Portuguese proposal work an alternative definition of club membership is needed. Signing up to the articles of contestability is not sufficient. Only companies that have contestable control can use the provisions of the Directive that make the control of potential targets contestable. In practice it will be difficult to define whether a bidder has contestable control or not. At the moment, even under a loose definition of contestable control, few listed companies in Europe would qualify for having access to the Directive's "articles of contestability" (Articles 9 and 11).

To avoid the creation of a club with no members, more radical contestability instruments are needed. To make blockholder control contestable, the Takeover Directive will have to convert blockholder controlled companies into widely held companies, at least in terms of voting rights. To achieve this aim the Directive would have to (re)introduce the "one-member-one-vote" (common law) principle that was the norm in early 19th century charters in Germany, France, the United Kingdom and the United States (Dunlavy 1996). Irrespectively of the number of shares owned, each shareholder has one vote.[29] Voting right ceilings and voting scales achieve similar results.[30]

However, voting right ceilings - on their own – do not fully open up the companies to hostile bids. On the contrary, voting right ceilings are themselves a powerful pre-bid takeover defence.[31] To eliminate this "dark side" of the "one-member-one-vote" rule, a radical ("Italian-style" or "0%") breakthrough rule is required. When a bidder launches a full offer to acquire all the shares of a company, the voting right ceiling is not binding. All shares can be fully tendered, all statutory defences are suspended and the bidder, with 50% or more acceptances, can take full control of the target. After the takeover is complete the bidder can

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However, there is an interesting contradiction in objectives. If the Takeover Directive aims at stimulating a European market for corporate control, it should explicitly allow dual-class share capitalizations. Dual-class structures make it cheaper.

[29] Formal or informal voting agreements between shareholders could be used to assemble "blocking minorities". With "one-member-one-vote" large coalitions would be needed, but to ensure that control is fully contestable it might be necessary to ban shareholder agreements altogether, or to limit the number of participants very severely.

[30] As a positive side-effect, voting right ceilings protect minority shareholders, another declared policy objective of the Takeover Directive.

[31] Voting right ceilings are statutory provisions and to be effective, they need to be locked in; with minority blocks (Figure 11) or priority shares. If "one-member-one-vote" is imposed by regulation the provision does not need to be locked in, making the defence even more formidable.

either take the company private, or the pre-bid reciprocity regime (voting ceiling plus "0%" breakthrough rule) applies, making control of the post-bid listed company contestable again.

Imposing a "one-member-one-vote" rule and a full "Italian-style" breakthrough rule would make the corporate control of listed companies contestable; adding the Portuguese "breakthrough club" proposal would achieve reciprocity in takeovers, at least for a subset of listed companies.[32] The current proposal of the European Parliament, combining the Winter Group proposal and the Portuguese proposal, will not achieve full reciprocity. Companies controlled by a majority blockholder can sign up to the new rules and will continue to be shielded from hostile bids, but they can bid for the control of widely held companies using the breakthrough rule (Article 11) and/or the board neutrality rule (Article 9).[33]

### *3.1 Precedents*

To my knowledge, a contestability *cum* reciprocity system like the one I just described does not exist, but there are some important precedents that can be found in the laws and rules of certain Member States, and in selected company statutes.

The Italian privatization law in force during in the hostile bid of Olivetti for Telecom Italia came close to what would be required for achieving contestability. Telecom Italia had been privatized with a voting ceiling. Although they had entered into a shareholder pact, the core shareholders could not exert a dominant influence over the company. Olivetti could break through the ceiling by making a bid for 100% of the shares. The Italian breakthrough rule also suspended the shareholder pact, allowing individual core shareholder to tender their shares to Olivetti. The proposed Directive's restrictions on post-bid defences applied. Telecom Italia's board sought rival bidders (a White Knight) and to merge with a subsidiary, but this action required shareholder approval. However, the Olivetti/Telecom Italia bid fell short of the full contestability *cum* reciprocity regime on two counts. One, the post-bid Telecom Italia continued to listed, but its control was no longer contestable; Olivetti held a majority stake (Figure 6).[34] Two, the control of Olivetti and of Tecnost, the bidding vehicle, was not contestable; Telecom Italia could not use a "Pac-Man" defense[35] and launch a counter-bid for Olivetti.[36]

In a more general sense the UK is already operating a system that combines a 30% voting power ceiling with managerial disciplining through hostile takeovers. The combination of the mandatory bid rule, the board neutrality rule and a (less well known) 30% "arm's length"

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[32] For minority shareholders of the target companies there would be a major shortcoming associated with this arrangement though. It would exclude non-listed companies from the group of potential bidders, reducing the chances of a bidding contest with multiple bidders (see below).

[33] In terms of the stylised systems set out in the previous section, achieving reciprocity in takeovers requires moving all listed companies from systems B1, B2 and W2 to system W1 *and* restricting the group of potential bidders to W1 companies.

[34] However, through a series of consolidations and the need to reduce the debt-mountain Olivetti had to accumulate during the bid the stake Olivetti holds in Telecom Italia has been reduced to approximately 12%, making the control of Telecom Italia contestable again.

[35] In the Pac-Man defense the target launches a hostile counter-bid for the bidder (named after the classic arcade game, where the PAC-MAN, munching pills and being chased by ghosts that try to deflate him, can eat a power capsule, turn on the Ghosts and eat them, for extra points).

[36] Also, the Italian government, through the Italian Treasury, could have vetoed the hostile acquisition.

rule[37] create a system that explicitly prevents 30%+ blockholder from exerting control, while allowing a "breakthrough" to full control of the company through a hostile bid, with squeeze-out provisions. In effect, the system is designed to generate a "bang-bang" equilibrium of corporate control: *Plc*s are either listed, widely held and open to hostile takeovers, or they are not listed and privately held. The whole system has been designed to satisfy a general, overriding principle - ensuring the equal treatment of *all* shareholders. There are no explicit rules on reciprocity in takeovers. On the contrary, anybody can launch a hostile bid, provided they follow the rules governing the bidding process.

Figure 12 shows a percentile plot of share blocks in FTSE 100, Midcap and Smallcap index companies. The mandatory bid/"arm's length" rule line at 30% is just visible, with few companies having large blockholders. Companies either have non-controlling shareholders holding blocks smaller than 30%, or they are privately held.

However, on several counts the UK system of voting control defies the general description and raises interesting questions for the reciprocity debate. One, the UK does not have reciprocity rules for takeovers and control contests are usually one-sided. Most listed UK plcs are open to hostile bids, but they are regularly taken over by bidders whose control is not contestable. Two, the UK's City Code does not actually ban pre-bid defences and some existing constructions go well beyond what is on offer in, for example, Germany and the Nordic countries (Figure 3).[38] Three, the 30% arm's length rule does not appear to have the same bite as, for example, a voting right ceiling. FTSE 100 companies like Associated British Foods plc and the Daily Mail and General Trust plc (DMGT, Figure 3) have majority blockholders and it is unclear how these companies can be run "independently of such large shareholders at all times". Moving down the scale, in the Midcap and Smallcap segments majority blockholders are more numerous and it is even harder to deny that they have the

[37] Article 3.12 of the UK's Listing Rules prescribes that "A company which has a controlling shareholder must be capable at all times of carrying on its business independently of such controlling shareholder […] and all transactions and relationships between the company and any controlling shareholder (or associate) must be at arm's length and on a normal commercial basis." Furthermore, Article 3.13 specifies that "For the purposes of paragraph 3.12, a controlling shareholder is any person (or persons acting jointly by agreement whether formal or otherwise) who is: (a) entitled to exercise, or to control the exercise of, 30% or more of the rights to vote at general meetings of the applicant; or (b) able to control the appointment of directors who are able to exercise a majority of votes at board meetings of the applicant."

[38] Looking across to continental Europe this begs the question why so many UK plcs have done away with takeover defenses voluntarily. The most plausible explanation appears to be the importance of institutional investor influence and power. After the first series of hostile bids in the 1960s, UK plcs did put into place pre-bid defenses (Franks, Mayer and Rossi 2003). However, after some hesitation, the financial establishment of the City of London decided that it supported control structures that featured a broad shareholder base, share liquidity and external challenges to control via the hostile bid instrument. The dismantling of hostile takeover protections was forced through by institutional shareholders (Franks, Mayer and Rossi 2003), in some cases only fairly recently (Black and Coffee 1990). One is tempted to extrapolate and argue that the growth of institutional investors will force the convergence of continental European control patterns on those found in the UK. However, it is not clear that this will be the case: Switzerland and the Netherlands have large pension funds, yet companies can and do use a broad range of pre-bid defenses. Looking from another angle, UK funds are increasingly investing in continental Europe, yet corporate control patterns in these countries have not changed dramatically, at least not yet.

(voting) power to influence the way the companies are run, at all times.[39] Finally, the "30% rule" is unlikely to explain why so many UK plcs are widely held;[40] UK plcs were widely held well before any formal listing rules were in force (Franks, Mayer and Rossi 2003).

Moving over to France, Alcatel S.A. has statutory control provisions that come closer to what one would expect to prevail if European corporations wanted to make their control more contestable. In accordance with a decision taken at the June 1989 annual meeting, Alcatel's statutes limit the voting power any shareholder, or group of shareholders, cannot exert more than 8% of the total votes that can be cast at the company's annual meeting (Annual Report 2002, pg. 139). Furthermore, the voting right restriction falls if a bidder acquires 66.66% of the total number of shares in the company, after bidding for all shares issued and outstanding (*opus cit*.).[41] Alcatel is widely held with the largest shareholder owning 5.91% of the shares, exercising 6.14% of the total voting rights. The combination of a statutory breakthrough rule with a voting right ceiling brings out the best in both measures, at least in theory.[42]

Although they are close to the full contestability *cum* reciprocity benchmark, the Alcatel provisions fall short of on three counts. One, the voting right ceiling is raised to 16% when a shareholder has acquired double voting rights by holding shares in the company for more than three years. Hence, an informal coalition of two large long-standing and one tiny shareholder could block any breakthrough. Two, Alcatel has disclosure provisions that force potential raiders to notify minuscule changes in their holdings, essentially preventing them from building a toehold, a serious deterrent for a potential bidder.[43] Three, the Alcatel statutes do *not* state that only companies on which Alcatel can launch a hostile bid can take advantage of its breakthrough rule.

I have discussed three regulatory experiments that have sought to make the control of European companies more contestable, with the Italian privatisation programme hitting coming closest to the mark. To my knowledge there are no precedents for reciprocity - limiting the pool of potential bidders to companies that are open to hostile bids themselves. Although not perfect, the existing experiments provide guidance for what would be required to create a market for hostile changes in control among listed companies through a European Takeover Directive. From a legal and intellectual perspective it is interesting to imagine such a European system being put in place. What ultimately matters though is whether a European market for corporate control would be conducive to fostering corporate restructuring, investment, employment and growth.

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[39] In the Midcap segment the Prudential and its subsidiaries hold a 79.3% stake in EGG Plc, its online banking arm. EGG's annual report states that "The relationship between the Company and Prudential plc is documented in a relationship agreement, which has been approved by the Board of Directors. Under this agreement Prudential plc is entitled to nominate one person to be a director of the Company. […] Prudential plc is also entitled to appoint any director to be Chairman of the Board (Annual Report pg. 34)." The Prudential has appointed two of its directors to the board of EGG plc but this is considered unproblematic because "All the remaining non-executive directors are independent and accordingly the Board is of the view that throughout the period, a majority of the non-executive directors were independent" (opus cit).

[40] Becht and Mayer (2002) and Goergen and Renneboog (2003) speculated that the 30% rule might act like a *de facto* voting right ceiling.

[41] The threshold of 66.66% gives a supermajority in France.

[42] In contrast Lafarge has a "pure" voting right ceiling, an arrangement that was imitated by Vivendi under Jean-Marie Messier.

[43] Toeholds are the most straightforward tool for overcoming the Grossman-Hart free-rider problem in hostile takeovers.

## 4 Contestability *cum* Reciprocity as a Policy Objective

The declared aim of the proposed Takeover Directive is to create a more vibrant market for corporate control in Europe while, at the same time, improving the protection of minority shareholders - without forgetting about the concerns of employees. A European market for corporate control is seen as an integral part of a single capital market and a major driver of European competitiveness, innovation and growth.

To be sure, reciprocity in takeovers is not required to create a European market for corporate control. At the European level, the creation of such a market only requires safeguards against discrimination of bidders and/or investors on the basis of nationality or location.[44] Reciprocity in takeovers is not required for minority protection either. Minority protection can be achieved through a mandatory bid rule or by rules that protect minorities directly, such as increased litigation rights.[45]

Reciprocity in takeovers is an issue because it was a latent aim of the Takeover Directive to make the voting control of European corporations more contestable. The proponents of reciprocity argue that in a market for *hostile* acquisitions of corporate control there should be a "level playing field"; all targets should have access to the Pac-Man defence. Hence, two questions arise: One, is it beneficial to push European corporations towards the widely-held model of corporate control, accepting external challenges to blockholder and board control? Two, does a European market for corporate control have to have a "level playing field" – does it require reciprocity in takeovers?

In theory there are substantial benefits the general endorsement of the widely-held model of the corporation could bring for Europe, in particular for Europe's capital markets. It is well documented that liquid markets are associated with lower transactions costs, lower expected returns and a lower cost of capital.[46] It is also documented that control blocks reduce liquidity, making it more difficult for investors to vote "with their feet".[47] Liquid stock markets also have the ability of carrying capital over "long distances", both geographically and between sectors (Holmström and Kaplan 2001). A more vibrant capital market, including hostile acquisitions, could help Europe move capital from sunset to sunrise industries (Berglöf *et. al.* 2003). In the United States, the hostile deals of the 1980s were associated with beneficial restructuring (Bhide 1989) that was successfully continued in the 1990s, having learnt the lessons of the 1980s (Holmström and Kaplan 2001).

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[44] In this context discrimination can take the form of exclusion and/or aiding national champions. Investors could be excluded from takeover offers based on their nationality and/or place of residence; or the acquisition programmes of national-champions could be subsidised through state aid.

[45] Indeed, as has been pointed out frequently, the mandatory bid rule is in contradiction to the first objective of creating a more active market for corporate control. The mandatory bid rule, and the mandatory disclosure of small toeholds, make the purchase of corporate control more expensive, discouraging the purchase of control blocks and corporate restructuring; see, for example, Becht, Bolton Roëll (2003), Franks (2003) and, especially, Berglöf and Burkart (2003).

[46] See Becht, Bolton and Roëll (2002), Section 7.2.3 for a survey.

[47] A number of commentators have pointed out that the Winter Group's breakthrough proposal, in its current form, might encourage the formation of larger blocks, as widely-held companies try to secure their statutory takeover protections through larger "one-share-one-vote" blocks (e.g. Becht 2002, Franks 2003). Hence, a partial implementation of the breakthrough rule might result in a reduction of stock market liquidity.

Attractive as the widely-held model of the corporation may be, at least for some companies and sectors, the recent corporate governance scandals in the United States and elsewhere have reminded us that widely held corporations are open to major abuses of power. Celebrity managers drove forward "visionary" plans under great market pressure and with very high powered incentives, unchallenged by weak boards and passive shareholders. There is scientific support for this popular scepticism. In theory hostile takeovers can overcome the managerial disciplining problems in widely-held corporations. In practice, hostile takeovers in the UK hit companies with good and poor prior performance at roughly the same rate (Franks, Mayer and Renneboog 2001). Good managers and poor managers are removed by hostile takeovers.[48] For tender offers more generally, target shareholders gain, but the combined return for bidders and targets is zero or negative (Andrade, Stafford and Mitchell 2002). Comparisons of relative performance are even less encouraging. There is some evidence that the return on a portfolio of widely held firms open to hostile takeovers and is higher than on widely held firms shielded from hostile takeovers (Gompers, Ishii and Metrick 2003).[49] However, comparisons of blockholder controlled companies and widely held companies are less encouraging. Companies with blockholders perform as well or better than widely held companies (Gugler 2002), with the latest studies finding that founder family controlled and operated firms in the United States show better performance than those in the hands of outsiders, or those under their *de facto* control (Anderson and Reeb 2003).[50] In theory, innovations like independent directors, incentives pay and hostile takeovers themselves could overcome the managerial incentives problems associated with widely held-corporation but, on balance, these methods have not yet been proven to be effective, at least not in a recent reading of the scientific literature (Becht, Bolton, Roëll 2003).[51]

Full reciprocity in takeovers goes even further than a general move to widely held corporations open to hostile bids. It would restrict the group of potential bidders to listed companies that are themselves open to hostile bids. From a theoretical perspective, this limitation is in conflict with the declared aim of protecting the minority shareholders of the target because it reduces the pool of potential bidders.[52] Empirically, there is strong and consistent evidence that multiple bidders are associated with higher premia for target shareholders, in both the US[53] and in the UK[54]. Hence, reciprocity is likely to hurt the minority shareholders the Directive wants to protect. Full reciprocity would also hinder and/or distort corporate restructuring. Large non-listed companies like JCB plc, Bosch GmbH,

[48] It is possible, of course, that the poorly performing targets are hit for disciplining reasons and the well performing targets for other reasons, for example product market considerations, but given the broad range of control variables in the study this is not very likely.

[49] Even here one can speculate if the higher returns do not simply capture anticipated takeover premia for target shareholders (Becht, Bolton and Roëll 2003).

[50] However, due to the inherent econometric difficulties results from this line of empirical research should be treated with great caution (Börsch-Supan and Köke 2001, Becht, Bolton and Roëll 2002, Bohren and Odegaard 2003).

[51] See Holmström and Kaplan (2003) for a positive assessment of the US corporate governance system that is dominated by widely held corporations, some open to hostile takeovers.

[52] Multiple bidders in takeovers have been analyzed theoretically by e.g. Fishman (1988), Burkart (1995) and Bulow, Huang and Klemperer (1999).

[53] See Michel and Shaked (1988), Bradley, Desai and Kim (1988), Banerjee and Owers (1996), De, Fedenia and Triantis (1996), Lefanowicz and Robinson (2000).

[54] Franks, Harris and Mayer (1988), Franks and Harris (1989).

Bertelsmann AG or Bechtel Corporation would not be able to use the new instruments the Directive provides to gain control of suitable targets, while less suitable listed competitors would be able get control.

## 5 Conclusion

A significant number of European Parliamentarians and Member States have made it clear that a European Takeover Directive that makes the control of listed companies more contestable must achieve full reciprocity between targets and bidders, or they will refuse to adopt it. I have shown that the implementation of this condition requires radical measures that could result in a massive transformation of corporate control in Europe. To meet the reciprocity condition, outsiders launching a full bid for a listed company in the European Union must be given the unconditional power to break the grip of incumbent blockholders and to break through structural takeover defences that protect incumbent boards – provided the target can do the same in a "pac-man" defence.

The benefits of such a transformation are not certain. Widely-held companies were the favourite corporate flavour during the late 1990s, but there is little scientific evidence to support this general preference. On the contrary, it has yet to be proven that independent directors, litigation, institutional shareholder activism and hostile takeovers can overcome the governance problems the separation of ownership and control in the widely-held corporation brings about – and act as substitutes for traditional blockholder monitoring.

On the other hand, European stock markets do suffer from a lack of liquidity that is largely induced by the concentration of corporate equity bases. Broadening the shareholder base, at the expense of blockholders, would not doubt help in pumping up volumes and bringing down transaction costs. However, the benefits must be weighed against the potential cost. Introducing mandatory contestability and reciprocity for listed companies via a European Directive imposes severe restrictions on the freedom of contracting between shareholders and corporations across the European Union. In light of the limited and contradictory evidence on the superiority of the widely-held corporation and the benefits of hostile takeovers, it is hard to justify such a drastic public policy intervention. In this respect the often cited example of the UK, the most hostile takeover friendly market in the world, is highly subversive. It suggests that widely-held companies arise "naturally" over time and that the strengthening of institutional shareholder voice should have priority over breakthrough rules.[55] Furthermore, the available scientific evidence from the UK suggests that hostile takeovers, non-executive directors and institutional activism have – at least until recently – not solved all corporate governance problems of the widely-held public corporation.

In the light of the available evidence it would be equally hazardous to reject the idea of promoting contestable control outright. A politically and practically desirable way forward is a Directive (or Regulation) that broadens the menu of instruments for conducting hostile takeovers. Neither voting right ceilings nor a radical "0%" breakthrough rule are available in all Member States. German companies that wish to embrace a French-style arrangement of

[55] Indeed, the evolution of ownership and control at Telecom Italia is an example of the pressures institutional investors are able to exert on large blue-chip corporations in Europe already.

contestable control would have to re-register in France, but the "0%" breakthrough rule is not available in France either. Instead of reducing the menu of available voting control structures the Takeover, or another Directive, should give companies access to additional tools that are needed for the adoption of widely-held contestable control structures. Backed by market pressure, such a Directive would facilitate the creation of "revolutionary" pan-European market segments, for example a widely-held segment that combines voting right ceilings (explicit curbs on blockholder power), a full breakthrough rule and a procedure that gives minority shareholders the right to nominate candidates for election to the board.[56]

Against this background one has to wonder why some European politicians are pushing so hard for full mandatory contestability and reciprocity in takeovers for all listed companies, in particular those who have traditionally shown little interest in making the control of European corporations more contestable. Given the history of the Takeover Directive one cannot fail to suspect a Machiavellian plot most foul; by asking for everything, they hope to get nothing. Given the theoretical and empirical uncertainties surrounding an untried reciprocity experiment this might not be the worst possible outcome. Giving stock markets a tool for creating a pan-European market segment companies that want to embrace contestable control can list on, with or without reciprocity, is preferable. Implementing the current proposals as they stand will not achieve much, one-way or the other. If anything, they will add another level of complexity and confusion to the prevailing systems of corporate control in Europe.

[56] The latter feature is highly controversial and the centre of debate in the United States at the moment; see Bebchuk (2003) for a forceful plead in favour of shareholder access to the corporate ballot box. For Europe's widely held corporations, a debate on corporate elections is bound to follow.

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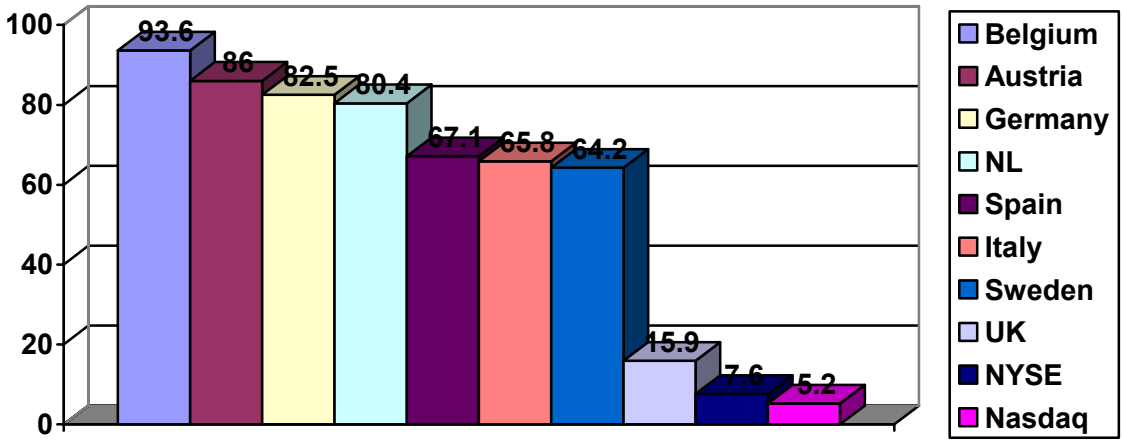
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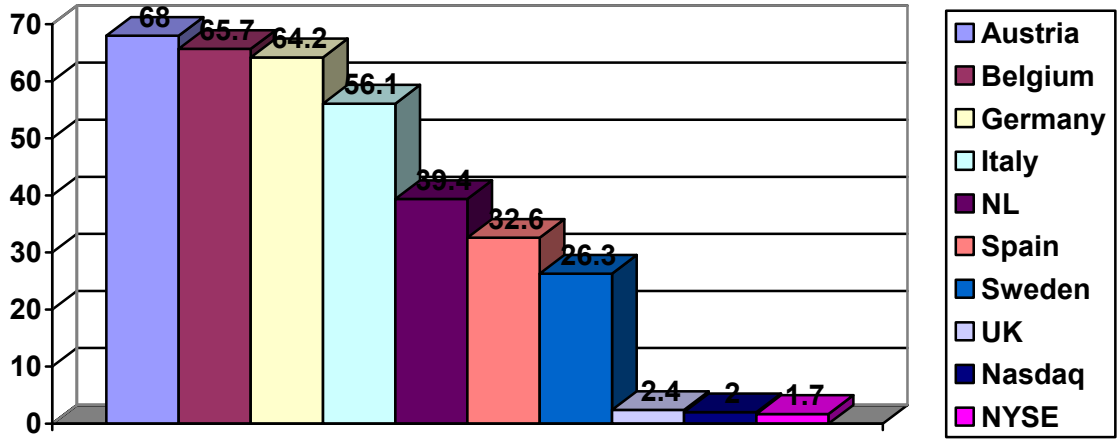
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**Figure 1. Percentage of Listed Companies with a blocking minority of at least 25%**



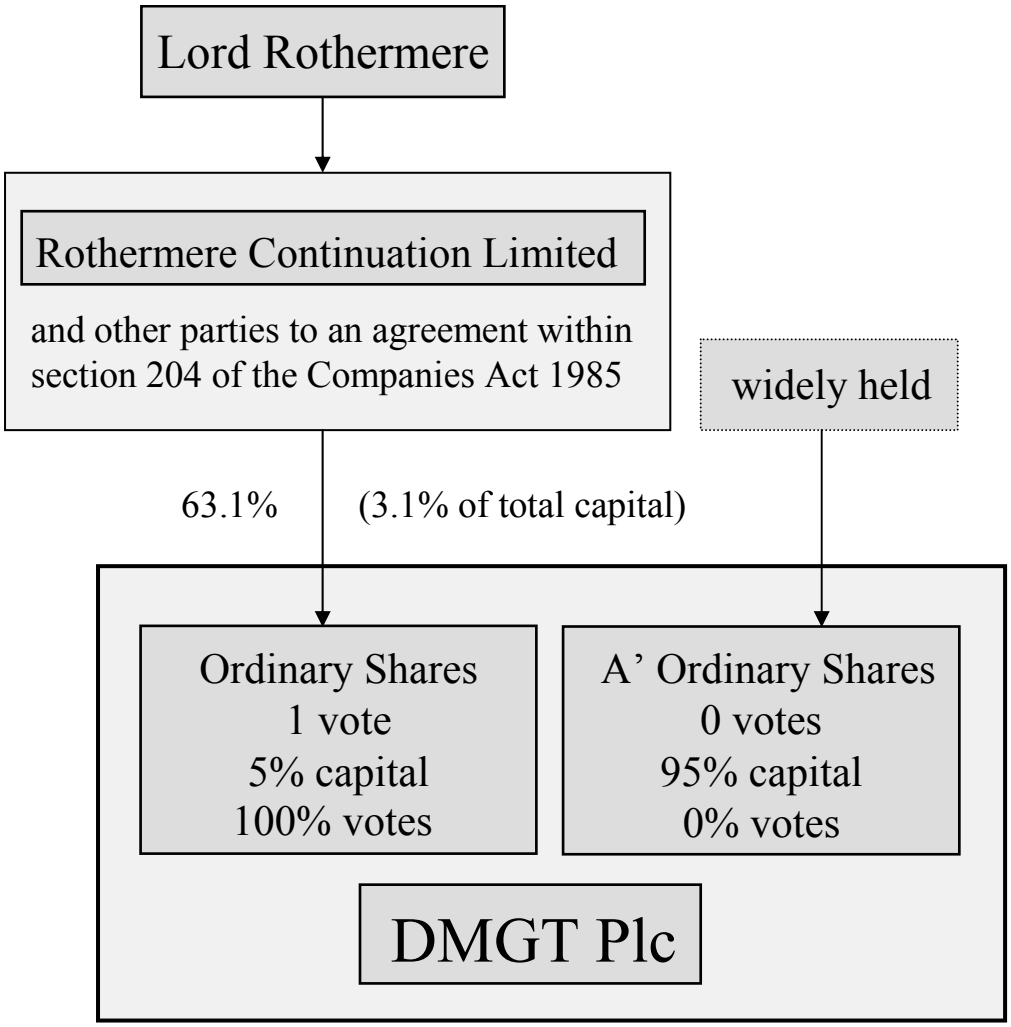

Source : Barca and Becht (2001), *The Control of Corporate Europe*, OUP

**Figure 2. Percentage of Listed Companies under Majority Control**




Source : Barca and Becht (2001), *The Control of Corporate Europe*, OUP

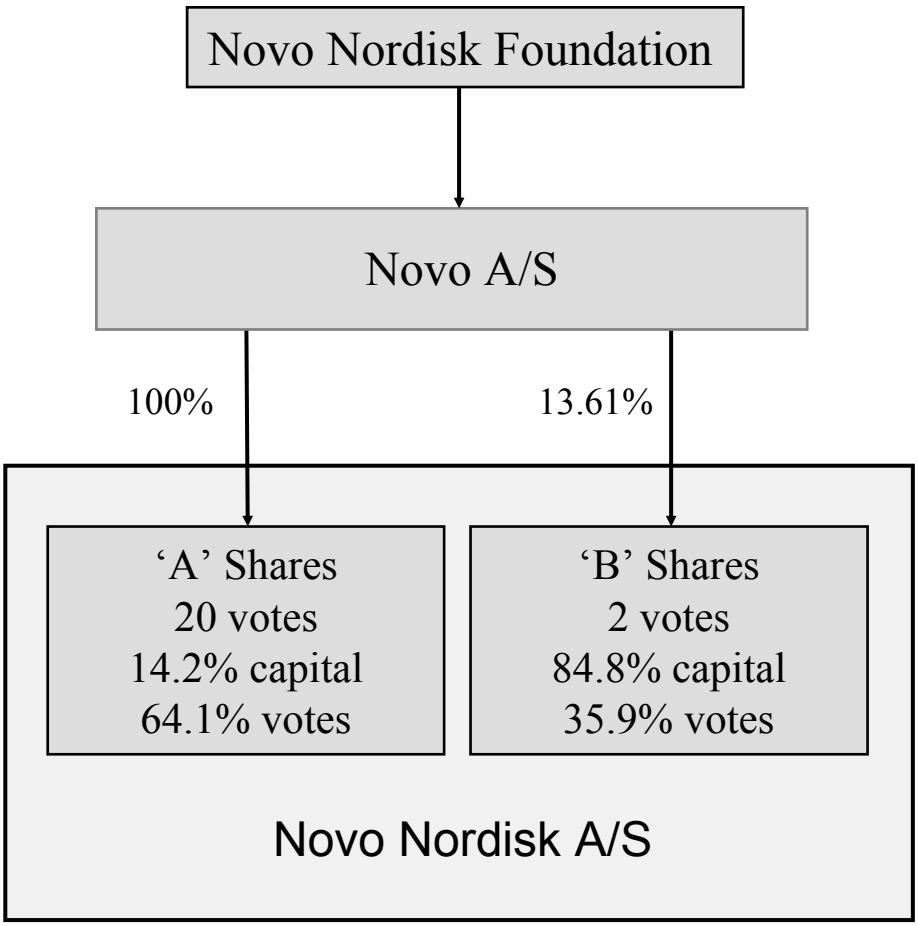
**Figure 3. Control Structure DMGT Plc**




Note : DMGT Plc has a dual-class share structure with £2.5m ordinary shares and £47.6m 'A' non-voting ordinary shares allotted and fully paid up. 'A' shares have no voting rights, otherwise the shares are identical. Lord Rothermere has declared to be the ultimate controlling party of the Group, via Rothermere Continuation Limited and other parties to and agreement within section 204 of the Companies Act of 1985 holding 63.1% of the voting shares. A second block of 25.2% of the voting shares is held by the Codan Trust Company Ltd and Rothschild Trust (Bermuda) Ltd, trustees of the Esmond Harmsworth 1998 Settlement. Dual-class capitalizations are not common among listed companies in the U.K., although U.K. company law allows for substantial voting control leverage. In Germany, for example, no more than 50% of the equity capital can be issued as non-voting shares.

Source : DMGT Plc Annual Report 2002 and own calculations

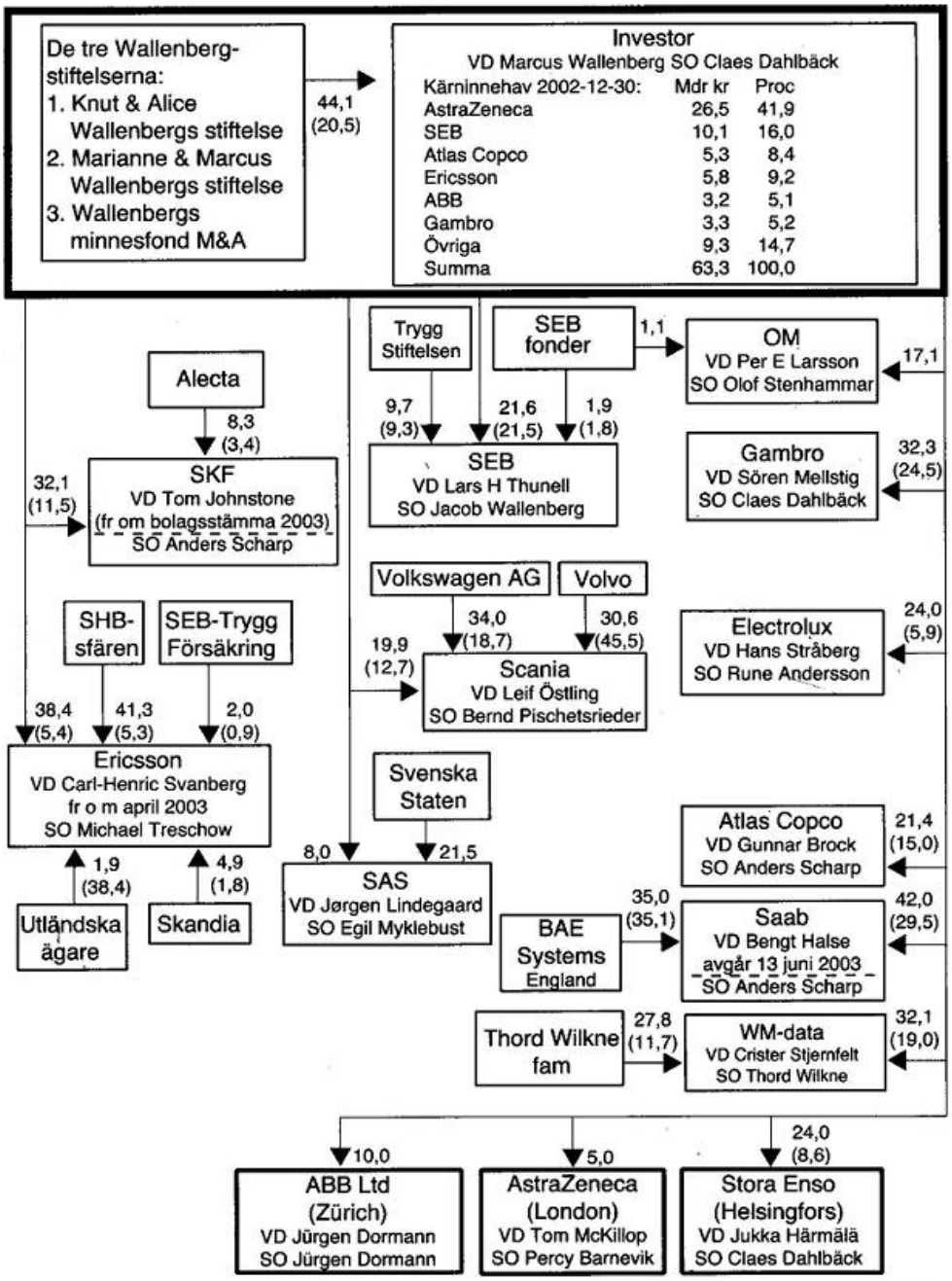
**Figure 4. Control Structure of Novo Nordisk A/S**




Note : Novo Nordisk A/S is controlled by the Novo Nordisk Foundation (via Novo A/S) that commands 64.1% of the votes with 14.2% of the capital by holding all "A" shares, and an additional 4.95% of the votes by holding 13.61% of the "B" shares. The other "B" shares are widely held. Its statutes require the foundation to maintain material influence over Novo A/S and Novo Nordisk A/S and to protect the interest of the companies. The Foundation may not, for example, sell the "A" shares it holds. Changes in the statues would require a two thirds majority of the members of the Foundation's board and approval by the Danish foundation authorities.

Source : Form 20-F 2002 and Company Web-site (www.novonordisk.com)

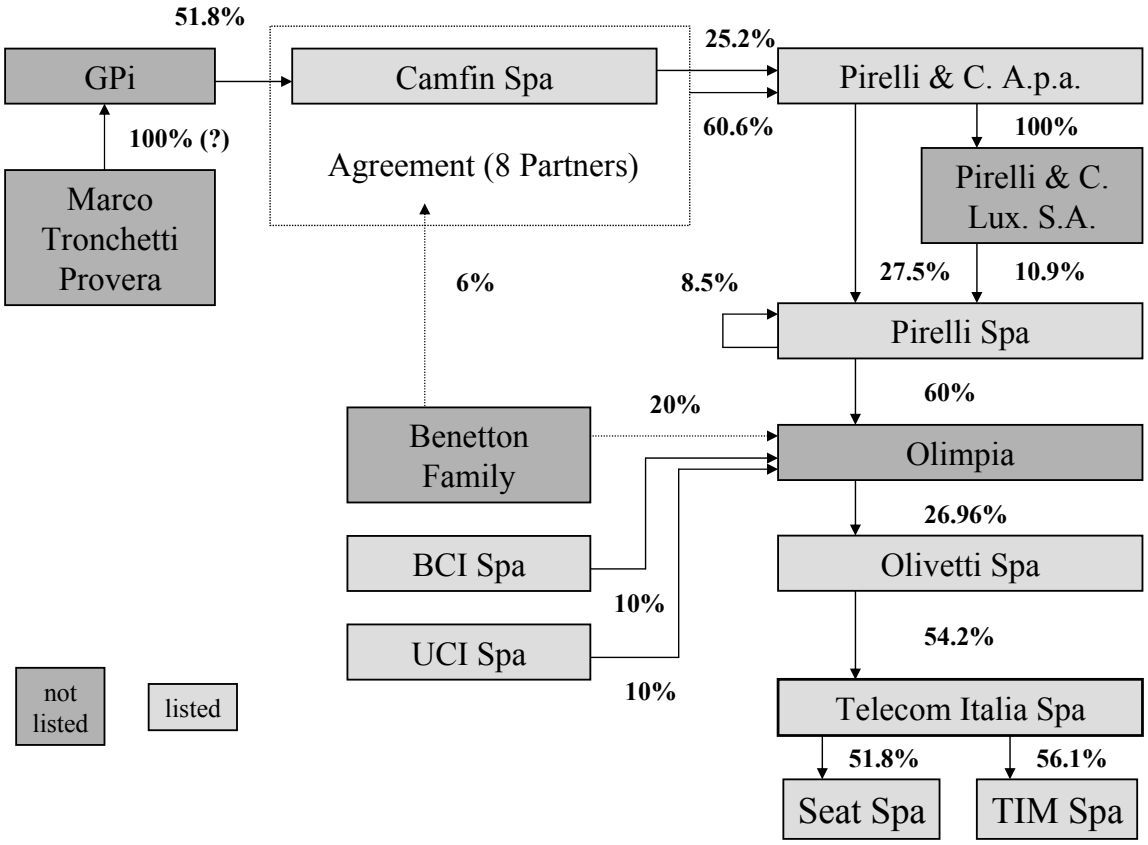
**Figure 5. The Wallenberg Pyramid**




Source : Fristedt, Sundin and Sundqvist (2003), Owners and Power in Sweden's Listed Companies (Ägarna Och Makten i Sveriges Börsföretag), Stockholm, SIS Ägarservice AB

Note : Capital links in percent; corresponding percentage of votes in brackets.

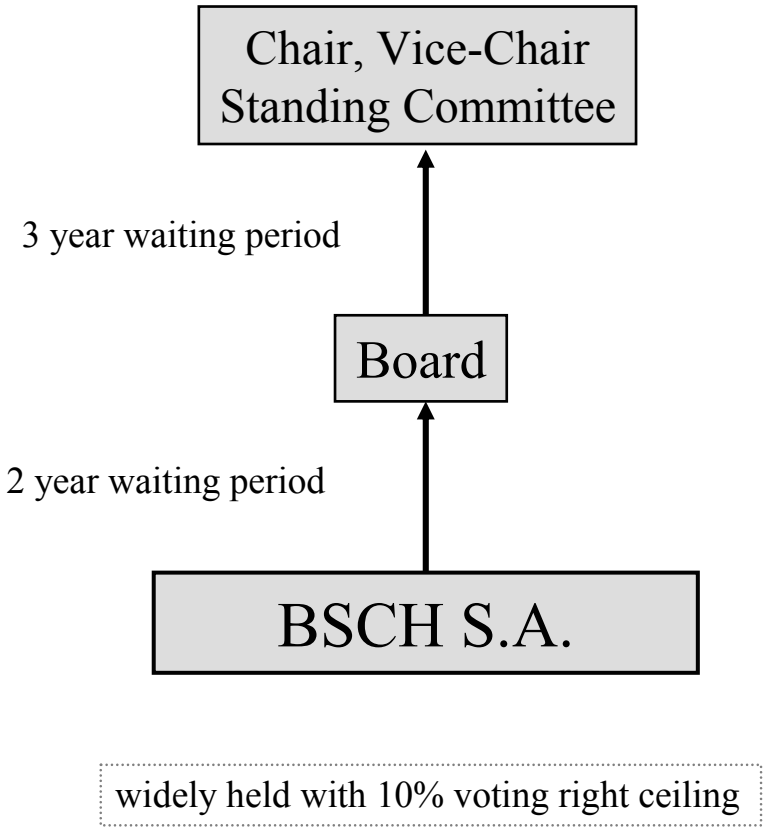
**Figure 6. The Telecom Italia Pyramid**




Note : The Telecom Italia pyramid is controlled by Marco Tronchetti Provera, with private equity from the Benetton family, two Italian banks (BCI and UCI) and other partners. The group originates with the leveraged hostile takeover of Telecom Italia by Olivetti. In 2003 the structure was simplified by merging Olivetti and Telecom Italia with Olimpia holding a mere 11.57% of the combined company in August 2003.

Source : Consob filings (June 2002) and www.telecomitalia.it (October 2003)

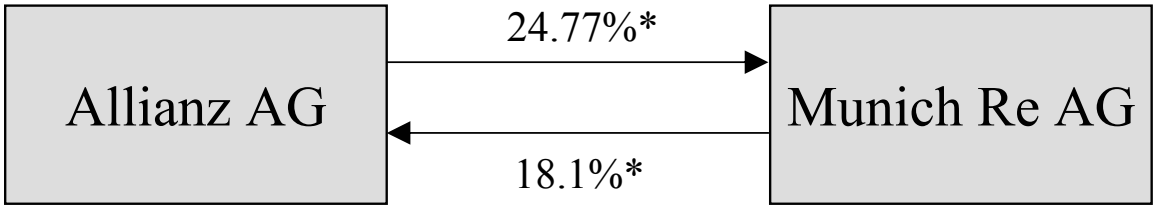
**Figure 7. Former Control Structure of Banco Santander Central Hispano S.A.**




Note : The takeover defenses at BSCH combines a 10% voting right restriction with waiting periods for gaining access to important board positions. A potential raider must have been a shareholder for two years to gain a board seat and a member of the board for three years before becoming eligible for election to key positions, like the chairmanship, vice-chairmanship or the powerful standing committee. The arrangement is secured through a 70% supermajority amendment, allowing a 30% coalition to prevent a raider from removing the statutory defenses from the statutes. BSCH voluntarily dismantled these defensive structures in June 2003.

Source : Company Statutes, Company Web-site (www.bsch.es)

**Figure 8. Control Structure of Allianz AG and Munich Re AG**

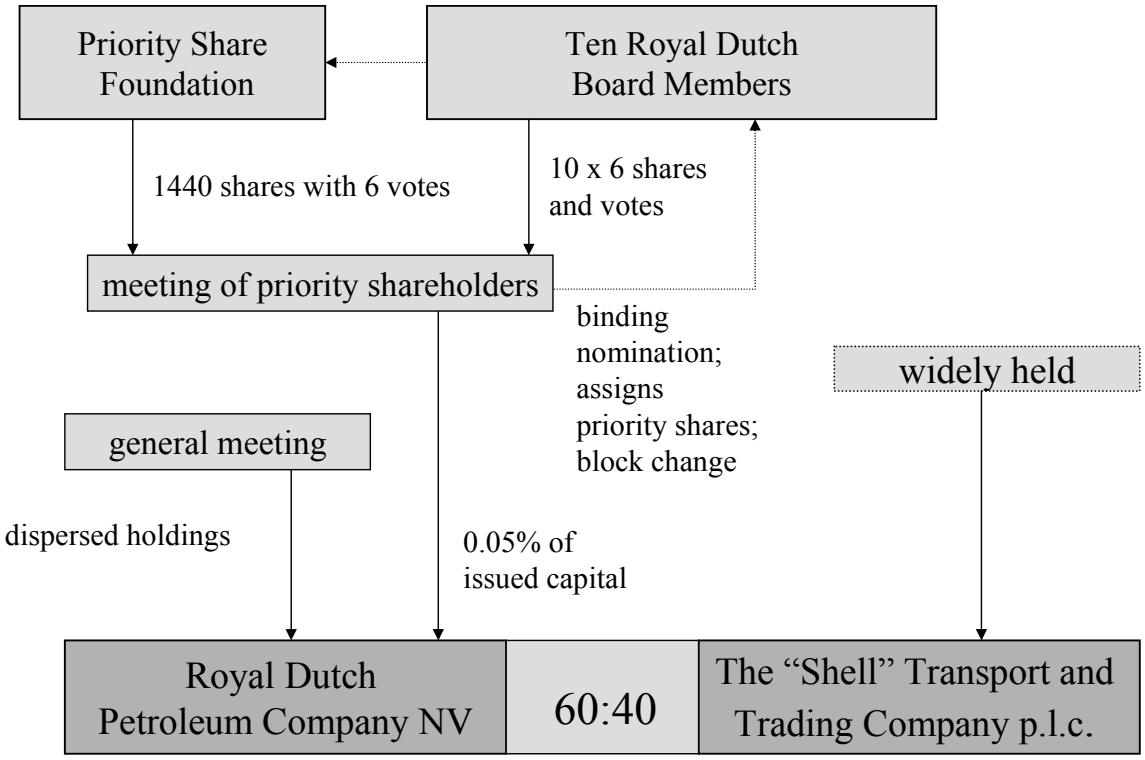



*voting rights controlled directly and indirectly

Notes : Allianz AG and Munich Re AG have a cross-holding that secures statutory provisions allowing the companies to refuse the transfer of shares. The companies can only refuse the transfer of shares "in extraordinary circumstances when considered essential for the company" (Allianz AG Statutes, Article 2(2)). Share transfer restrictions are common among German insurance companies and often date back to their foundation, for example in the case of Munich Re.

Source : Company web-sites (www.allianz.de, www.munichre.de) and BaFin (www.bafin.de)

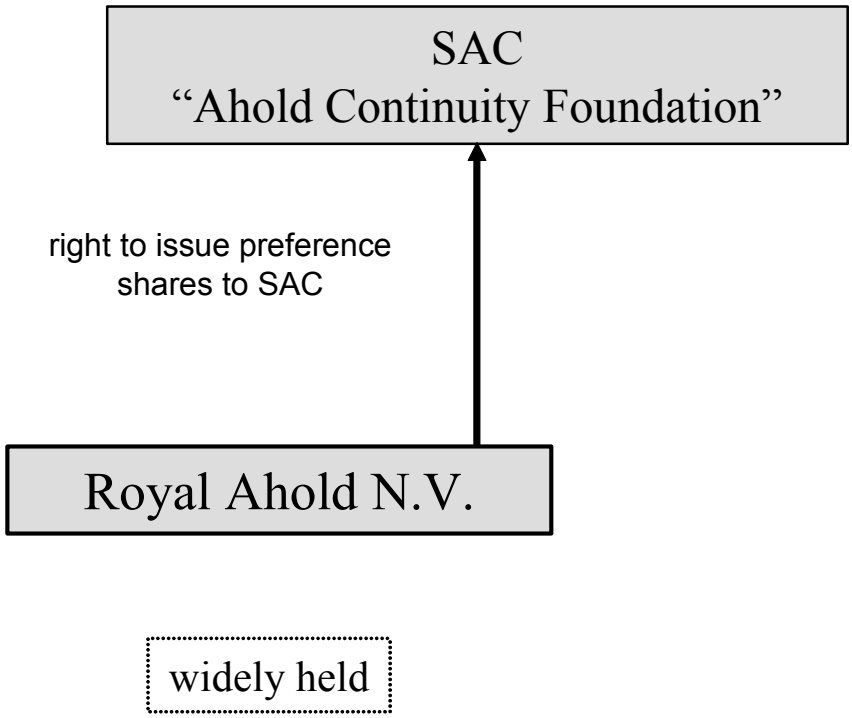
**Figure 9. Corporate Control of Royal Dutch/Shell**




Note : Royal Dutch/Shell is an Anglo-Dutch company tied together through contracts and equalization agreements. The Shell Transport and Trading Company plc is widely held and controls 40% of the underlying assets of the group. The Royal Dutch Petroleum Company NV controls 60% of the underlying assets. The Dutch company has two classes of shares: ordinary shares that are widely held and constitute the bulk of the capital that has been issued and is outstanding; priority shares that make up a tiny proportion of the issued capital put have special rights. The most important rights include the drawing up of binding nominations consisting of two people for the managing and supervisory board, the right to veto changes to the Article of Association of Royal Dutch (lock-in) and a veto on the transfer of priority shares.

Source : Form 20-F 2002

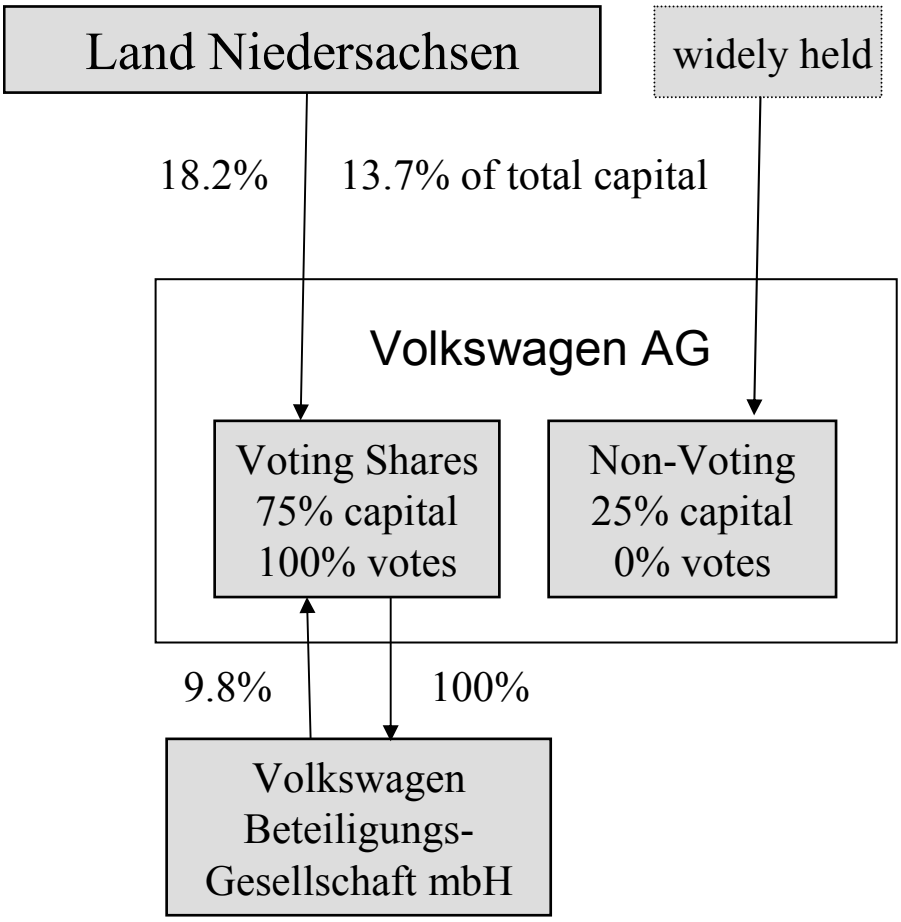
**Figure 10. Takeover Defences of Royal Ahold N.V.**




Note : Royal Ahold N.V. is widely held and uses authorized preference shares that can be issued to the friendly SAC "Ahold Continuity Foundation" to defend against takeovers. In particular SAC has been granted an option to acquire from Ahold cumulative preferred shares "up to a total par value that is equal to the total par value of all issued and outstanding shares of our capital stock, excluding cumulative preferred shares, at the time of exercising the option. The holders of the cumulative preferred shares are entitled to 2,000 votes per share and a cumulative dividend. expressed as a percentage of the amount called-up and paid-up on the cumulative preferred shares. […] We may stipulate that only 25% of the par value will be paid upon subscription for cumulative preferred shares until payment in full of the par value is later called by us." In the fiscal years 2000 and 2001 no preference shares were issued or outstanding. The arrangement provides a very powerful takeover defence, despite a broad shareholder base and high secondary market liquidity in the ordinary shares.

Source : Form 20-F 2002, page 179

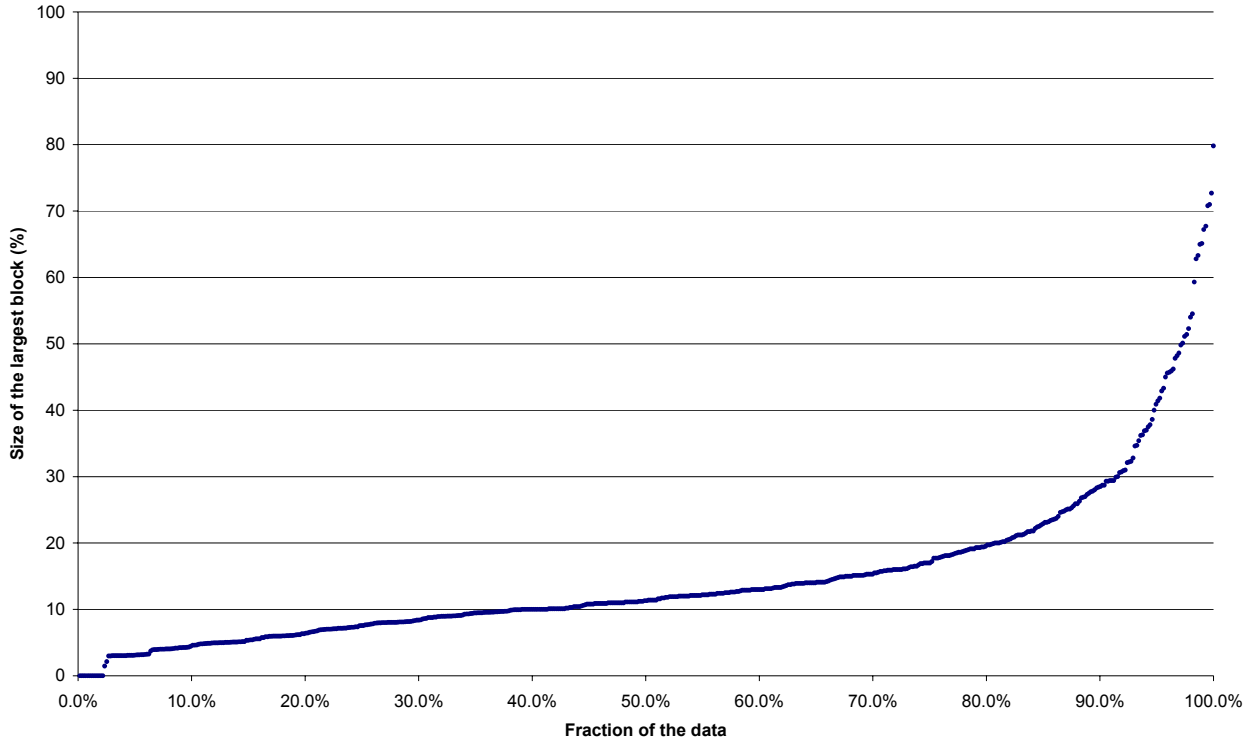
**Figure 11. Corporate Control of Volkswagen AG**




Note : Volkswagen AG combines an 80% supermajority amendment with a 20% voting right restriction and a blocking minority that is obtained with a dual-class share structure. In addition the state of *Niedersachsen* has the right to appoint two out of ten supervisory board members on the capital side.

Source : Volkswagen Annual Report 2002, Company Statutes

**Figure 12. Percentile Plot for Largest Block in FTSE 100, Midcap and Smallcap Index Companies**




Note : The horizontal axis shows the fraction of UK listed companies in the FTSE 100, Midcap and Smallcap indices after sorting the companies by the size of their largest blockholder. The vertical axis plots the size of the largest shareholding.

Source : Hemscott REFS, July 2002 and own calculations

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