Make It or Break It: The Break-Through Rule as a Break-Through for the European Takeover Directive?

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Abstract

The break-through concept is the most recent idea to break the deadlock with respect to EU takeover legislation. As devised by the High-Level Group of Company Law Experts, chaired by the Dutch Jaap Winter, the break-through concept would do away with two of the most important types of impediments to takeovers within EU member states. The first part of the paper explores the break-through concept in some detail, particularly with respect to its premises, its two guiding principles – exclusive shareholder decision-making and proportionality -, and the justifications given by the Group for the proposed interventionist rules. The second part of the paper is dedicated to an analysis of the economic effects of the two guiding principles, and in particular of the proposed "one share one vote"-regime. While there is good reason to support the principle of exclusive shareholder decision-making with respect to takeovers the rationale for a strict "one share one vote"-regime is more difficult to defend given the mandatory bid rule as an another core element of European takeover legislation. In all, the economic analysis presented in this paper supports the view that given a mandatory bid regime there is no need for European takeover regulation to incorporate an all-encompassing break-through concept based on "one share, one vote". On the other hand, apart from raising some difficult new problems the analysis does not identify any compelling argument against the introduction of such a rule either. Thus, it remains to be seen whether the break-through rule dead-ends all efforts of introducing a European takeover regulation or, on the contrary, acts as a catalyst that enables the EU finally to break through to the adoption of a Takeover Directive. The EU Commission, at least, because of strong political resistance from various interested parties only adopted a somewhat watered-down version of the break-through concept in its most recent proposal for a takeover directive of 2 October 2002.

Keywords: European takeover directive, break-through rule, mandatory bid, "one share one vote", Report of the High-Level Group of Company Law Experts on Issues Related to Takeover Bids, anti-takeover defenses, shareholder vote, multiple voting rights

JEL Classifications: G32, G38, K22

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I. Introduction

The concept of a break-through rule is the most recent idea to emerge in the long-standing discussion regarding EU takeover regulation. Broadly understood, the term "break-through rule" refers to any provision that dispenses with either of two types of impediments to takeovers. The first of these impediments is legal structures and mechanisms that prevent shareholders from reacting to a takeover bid either by tendering their shares to the bidder or by voting on the authorization (or non-authorization) of defensive measures. The second impediment is legal structures that prevent a bidder from exercising control once he has successfully completed his bid and acquired a nominally controlling position in the firm. Both types of impediments are targeted in various ways by the different break-through rules that to date have been presented at the EU level:

The High-Level Group of Company Law Experts, in its "Report of the High-Level Group of Company Law Experts on Issues Related to Takeover Bids,"[1] used the term "break-through rule" with only the second of the above meanings, i.e., with respect to a post-completion break-through. In this vein, the Group recommended a post-completion rule requiring that, for the purpose of shareholder voting in a shareholder assembly, provisions in the articles of association and other constitutional documents of the target company deviating from the principle of "one share, one vote" be overridden immediately upon the offeror having successfully completed the bid by acquiring at least 75% of all "shares" (recommendations I.4 - I.7). Predictably, this proposal met with only partial approval. The EU Commission, in particular, adopted a watered-down version of the post-completion break-through rule in its new proposal for a takeover directive[2]. Art. 11 Para. 4, in its present form, deals only with private-law restrictions on the transfer of securities and the exercise of voting rights as well as with any special rights of shareholders concerning the appointment or removal of board members and renders them unenforceable or ineffective at the first general meeting following closure of the bid. Professors Dauner-Lieb and Lamandini, on the other hand, in a subsequent study[3] commissioned by the Committee on Legal Affairs and the Internal Market of the EU Parliament, endorsed the original version of the rule, at least in principle, and

[1] Report of the High-Level Group of Company Law Experts on Issues Related to Takeover Bids of 10 January 2002 (hereinafter referred to as „HLG Report") (download at http://www.europa.eu.int/comm/internal_market/en/company/company/news/hlg01-2002.pdf).
[2] Commission Communication on the proposal for a Directive of the European Parliament and the Council on takeover bids of 2 October 2002 (download at http://www.ecgi.org/takeovers/documents/european/proposal_english.pdf). The proposal itself is contained in the document COM(2002)534 final and published in Official Journal C 45 of 25 February 2003, p. 1-17 (download at http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0534en01.pdf).
[3] Dauner-Lieb/Lamandini, The New Proposal of a Directive on Company Law concerning Takeover Bids and the Achievement of a Level Playing Field with Particular Reference to the Recommendations of the High Level Group of Company Law Experts set up by the European Commission (download at http://www.europarl.eu.int/comparl/juri/studies/study_complaw_en.pdf).

recommended an extension of the rule to include, inter alia, multiple voting rights and, within certain limits, non-voting shares carrying specific pecuniary advantages[4]. Since then, Klaus-Heiner Lehne, as rapporteur to the Committee on Legal Affairs and the Internal Market on the takeover directive, has adopted a similar position. In a preliminary draft of his report to the Committee, he recommended that Art. 11 Para. 4 be altered so that multiple voting rights – but not non-voting shares carrying specific pecuniary advantages - will also fall within the ambit of the break-through rule.[5]

With regard to the decision of the target's shareholders regarding the bid, the High-Level Group recommended two rules: (i) that provisions in the articles of association and other constitutional documents deviating from the principle of "one share, one vote" be overridden in the shareholder meeting required to authorize any defensive action by management that would frustrate the bid (recommendation I.3); and (ii) that provisions in the articles of association and related constitutional documents that restrict the transferability of shares not be enforceable against the selling shareholder or the buying bidder, respectively (recommendation I.9).[6] Furthermore, the Group concluded that the EU Commission should consider the introduction of a rule providing that shareholder agreements that prohibit the transfer of shares not be enforceable against the seller (recommendation I.10). With the exception of securities without voting rights that carry specific pecuniary advantages (Art. 11 Para. 5) [7], the Commission followed these recommendations to some extent. Art. 11 Para. 2 of the draft Takeover Directive provides for the unenforceability of all statutory or contractual transfer restrictions, whereas Para. 3 provides for the ineffectiveness of all statutory or contractual restrictions on voting rights in the case of a decision of the shareholder meeting regarding any defensive measures. In contrast, Professors Dauner-Lieb and Lamandini, as well as Klaus-Heiner Lehne as rapporteur, again supported the extensions outlined above to, at a minimum, shares with double or multiple voting rights.

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[4] Dauner-Lieb/Lamandini (N. 3), p. 36 et seq., 59 (summary).

[5] Draft Report on the proposal for a European Parliament and Council directive of on takeover bids of 11 March 2003, PE 327.239 (download at http://www.ecgi.org/takeovers/documents/european/htsdesktakeover.pdf).

[6] The recommendation refers only to restrictions on the transferability of non-listed shares, pointing out that the Council Directive of 5 March of 1979 coordinating the conditions for the admission of securities to official stock exchange listing (Official Journal L 66, 16.3.1979, p. 21; download at http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=31979L0279&model=guichett) requires for the admission of shares to the official stock exchange listing that the shares must be freely negotiable (Schedule A Chapter 2 Para. 2). However, while the Directive of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published regarding those securities (Official Journal L 184, 6.7.2001, p. 1; download at http://europa.eu.int/eur-lex/pri/en/oj/dat/2001/l_184/l_18420010706en00010066.pdf) replaced the older listing directive, the admission of shares that may be acquired only subject to approval is still allowed provided that the use of the approval clause does not disturb the market (Art. 46 Para. 3 of the Directive).

[7] The rationale underlying this provision is somewhat difficult to understand. Art. 2 Para. 1 lit. E of the draft Takeover Directive defines "securities" as transferable securities carrying specific voting rights in a company. Thus, non-voting preferrence shares are excluded anyway.

The mixed reception of the break-through concept, and in particular of the post-completion break-through rule, by Member States and by other interested parties as well as by academics[8] may be read as an indication that this interventionist approach is fraught with substantial problems. Indeed, apart from obvious political considerations,[9] critics have raised serious objections on economic grounds and, furthermore, have pointed to legal problems caused by the introduction of a post-completion break-through rule. A more detailed discussion of these problems, however, first requires some clarification with regard to the underlying rationale for, as well as the different contents of, the break-through concept.

The remainder of the paper is organized as follows: Section II examines the approach of the High-Level Group in some detail. It describes core building blocks of the proposal and analyzes the line of reasoning employed by the Group to derive the break-through concept. Sections III and IV discuss the two guiding principles employed by the Group in some detail, particularly with respect to their justification on efficiency grounds. Section V offers some concluding remarks.

II. The Break-Through Concept of the High-Level Group

1. The Premise: the Creation of a Pan-European Level Playing Field

The High-Level Group arrived at the post-completion break-through rule as well as the related rules in three steps.[10] The Group began with the premise that any European takeover regulation should aim at creating a level playing field for EU cross-border takeovers despite existing differences in national company law mechanisms and structures, as well as substantial differences in the capital and control structures of companies from different Member States. The Group then went on to postulate that this objective should be realized by the application of two guiding principles, namely shareholder decision-making and proportionality between risk bearing

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[8] See, e.g., Berglöf/Burkhart, „Break-Through" in European Takeover Regulation?, Site Staff Paper 02/03 (Stockholm School of Economics), 2002 (download at http://web.hhs.se/site/Publications/staffpapers/SP0203Sep.pdf); Bebchuck /Hart, A threat to dual-class shares – The recommendation of the breakthrough rule fails to recognize its broader implications, Financial Times of 31 May 2002 (download at http://www.ecgi.org/takeovers/media/articles/bebchuk_hart_ft.pdf); Khachaturyan, Can Bolkestein Finally Break the Takeover Directive Deadlock?, CEPS Commentary 2003 (download at http://www.ceps.be/Commentary/Mar03/Khachaturyan.php); Uwe H. Schneider, Die Break-through-rule und die holländische Poison Pill, Börsenzeitung of 27 February 2002, p. 13. For a contrary view, see. e.g., Krause, Der Kommissionsvorschlag für eine Revitalisierung der EU-Übernahmerichtlinie, Betriebs-Berater 57 (2002), 2341, 2347.

[9] The number of companies affected by the break-through rule is unevenly distributed among Member States. Scandinavian, Italian and German companies would be affected in disproportionate high numbers. See in more detail Bennedsen/Nielsen, The impact of a break-through rule on European firms, Working Paper 12/2002, Copenhagen Business School (download at http://www.cbs.dk/departments/econ/res/wpec122002.pdf).

[10] As to the following, see HLG Report (N. 1), p. 20, 26.

and control. Finally, it concluded that these two principles can only achieve a level playing field if a takeover regulation provides for far-reaching break-through mechanisms during a bid and after its completion.

Upon closer inspection, this line of reasoning appears somewhat problematic. Obviously, any set of principles can lead to a level playing field provided that the principles and the rules derived from them are applicable to all market participants in a uniform manner. Thus, the two guiding principles selected by the High-Level Group to achieve a level playing field are in truth the (implicit) premises that underpin the rest of the Group's reasoning. In other words, given the premise that takeover regulation is governed by two principles - shareholder decision-making and proportionality - the creation of a level playing field for takeover bids requires, according to the High-Level Group, that there be some break-through mechanisms at work. The fact that the two principles are far more fundamental than the aim of creating a level playing field becomes even more apparent in the report delivered by the High-Level Group itself. Before working out the application of the two principles in the context of takeovers, the Group considered whether these two principles, being fundamental principles of company law in general, should be applied to all pre-bid structures and company law mechanisms that lead to a concentration of control rights in the hands of the board and/or shareholders. The Group refrained from going into details, however, pointing primarily to the short time given to produce to the report.[11]

The reason for the High-Level Group's election to proceed from the starting point of creation of a level playing field instead of from the two guiding principles is probably to be found in the terms of the Group's mandate from the EU Commission. According to these terms, one of the three matters for the Group to examine was the measures necessary to ensure the existence of a level playing field in the EU with regard to the equal treatment of shareholders among Member States.[12]

The mandate's terms of reference did not, however, specify any guidelines with respect to the measures that might be considered in order to create a level playing field. By choosing two particular guiding principles - shareholder decision-making and proportionality - the Group made fundamental policy decisions of its own choosing. Admittedly, Art. 9 Para. 2 of the draft Takeover Directive, as approved by the Conciliation Committee on 6 June 2001,[13] already enshrined the principle of shareholder decision-making by providing that, in order to take defensive measures in the face of a bid, the board of the target company must first obtain the prior authorization of the

[11] HLG Report (N. 1), p. 23 et seq.
[12] HLG Report (N. 1), p. 16, 70 (annex 1).
[13] Directive on company law concerning takeover bids, PE-CONS 3629/1/01 REV 1 of 19 June 2001 (annex 6 to the HLG Report).

general meeting of shareholders once a bid has been made. This provision, however, together with the lack of any break-through mechanisms as a means to create a level playing field, constituted one of the main reasons why the German rapporteur to the Committee on Legal Affairs and the Internal Market of the EU Parliament on the takeover directive, Klaus-Heiner Lehne, and the German government opposed the then-current draft of the directive and why the Parliament ultimately failed to adopt the directive by casting a tie vote.[14] Given this background, the Group could equally well have chosen another set of premises and could have come up with very different answers to the problem of establishing a level playing field. Therefore, an evaluation of the Group's break-through recommendations must start with a review of its premises, i.e., a review of the two guiding principles and the manner in which the Group applied them to takeover bids.

2. The Two Guiding Principles

a. Shareholder Decision-Making

Shareholder supremacy asserts itself primarily in the principle of shareholder decision-making. Applied in the context of a takeover bid, this principle, as developed by the High-Level Group, has two meanings:

First, it is exclusively up to the shareholders of the target company - and not to its management - to decide on the outcome of a takeover bid (recommendation I.2). If takeover law or company law allows any authorization of defensive measures by shareholder resolution, the shareholder decision-making comes in two forms: the decision whether to tender the shares (recommendations I.9 - I.10) and the vote in the shareholder meeting on the approval of such defensive measures (recommendation I.3). Furthermore, if the bidder succeeds in acquiring a controlling position, it is up to him to choose the new management team that will run the company (recommendations I.4. - I.7).

Second, only decisions of the target company's shareholders taken in reference to an actual bid are to be decisive for the outcome of that bid. Thus, prior to a bid being received, shareholders are not able to vest in the board the power to take defensive actions (recommendation I.2). Once shareholders have received a bid, statutory restrictions on the transfer of shares are not enforceable against the bidder or seller, respectively (recommendation I.9[15]). In the same vein, the Group

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[14] The events leading up to the tie vote of Parliament are outlined in the HLG Report (N. 1), p. 14 et seq. and in the Commission Communication (N. 2), p. 2; for a more detailed account see Gordon, An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000, Working Paper No. 108, p. 49 et seq. (download at www.uni-frankfurt.de/fb01/baums/).-

[15] As to the erroneous restriction of this recommendation to non-listed shares see supra N. 5.

recommends that the Commission at least consider a rule pursuant to which shareholder agreements that prohibit the transfer of shares to a bidder be unenforceable (recommendation I.10).

b. Proportionality

The principle of proportionality between risk-bearing and control in the context of a takeover bid as developed by the High-Level Group has two meanings as well:

First, all holders of risk-bearing capital, i.e., holders of rights to residual profits and/or assets of the company[16], are entitled to participate in shareholder decision-making with regard to takeover bids. Basically, that means that any holder of a residual right to the cash flow of the target company is entitled to take part in takeover-related decisions. This applies to decisions of the target company's shareholders on the outcome of a takeover bid - all holders of risk-bearing capital are entitled to vote on the authorization of defensive measures (recommendation I.3), and the unenforceability of transfer restrictions applies to all risk-bearing shares (recommendation I.9) - as well as to the vote on any shareholder resolution in a general meeting convened by the bidder after the successful completion of the bid (recommendation I.7[17]).

Second, all holders of risk-bearing capital are entitled to exercise votes in proportion to their holding of risk-bearing capital - for short, "one share, one vote." Again, this holds true for a shareholder resolution on the authorization of defensive measures[18] as well as for a vote on any shareholder resolution in a post-completion general meeting.[19]

3. The Justification of the Break-Through Concept

Accepting the two guiding principles and the aim of creating a level playing field as given still does not mean that, in order to reach this objective, European takeover regulation has to incorporate the broad break-through rules devised by the High-Level Group. The Group itself dealt in a rather summary fashion with the fundamental question of whether its broad break-through concept is necessary, justifiable or even advisable.[20] With regard to the principle of shareholder decision-making, the Group simply asserted that this is a necessary precondition for the full development of the European securities markets. Furthermore, it observed that, while a fully

[16] HLG Report (N. 1), p. 21.
[17] Not only the bidder but also other holders of risk-bearing capital should be entitled to vote in proportion to their holdings. See HLG Report (N. 1), p. 35.
[18] HLG Report (N. 1), p. 28
[19] HLG Report (N. 1), p. 32, 35.
[20] As to the following, see HLG Report (N. 1), p. 20 et seq.

integrated and well-developed securities market might do without the principle of proportionality, such efficient markets do not currently exist across Europe. Given this factual and legal environment within the EU, the Group concluded that, in order to establish securities markets in the EU which both are efficient and provide an adequate level of investor protection, more detailed break-through rules at the EU level were needed. Aside from three exceptions – "golden shares," contractual arrangements[21], and holding pyramids - these more detailed rules are designed to remove any deviation from the principle of "one share, one vote" as elaborated by the High-Level Group or, in other words, from the principle that "holders of risk-bearing securities are to decide takeover-relevant questions on a strictly proportional basis in the present."

In general, there are several levels on which to address the policy question of whether to introduce a break-through concept, e.g., political, economical and legal considerations. Apart from obvious fortunate coincidences on the political level - a full-scale break-through rule would to a large degree take account of Germany's objections with respect to board neutrality (Art. 9 of the draft Takeover Directive) the High-Level Group argues on an economic level by suggesting that only efficient securities markets can do without the principle of "one share, one vote," while the European factual and legal environment requires the elimination of national laws that allow for statutory and/or contractual takeover barriers in order to achieve efficient securities markets within the EU and a high(er) level of investor protection.

This argument is somewhat difficult to evaluate. In particular, the implied relationship between the relative degree of market efficiency and the need to remove statutory or contractual takeover barriers seems unclear. Indeed, if at least some European markets were informationally less efficient, these obstacles might be less accurately reflected in stock prices. The deviations, however, might be randomly distributed - and in that case takeover barriers would probably curtail takeover activity no more than in an informationally efficient market. The Group's additional assertion that, in the long run, structures deviating from the two guiding principles should wither and die out in efficient markets, except to the extent that they are justified by the particular circumstances of a company, is at least not corroborated by circumstantial evidence (e.g., Ford Motor Company). More generally speaking, so far even US companies have been far more likely to introduce additional takeover defenses than to abolish existing ones. In the same vein, in the past decade, a considerable number of companies went public in the US securities markets with rather strong anti-takeover defenses in place.[22]

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[21] As to a possible exception with respect to shareholder agreements that prohibit the transfer of shares, see recommendation I.10.

[22] See Daines/Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Provisions in IPOs, Journal of Law, Economics and Organization 17 (2001), 83, 95 et seq.; in particular with respect to dual-class share IPOs – ordinary common stock is issued to the public while insiders retain a class of shares with superior voting rights – see

It is even more difficult to see why allocatively less efficient markets would of necessity suffer more heavily from barriers to takeovers than more efficient ones. Admittedly, such obstacles might be the cause of additional allocative inefficiencies. But why should these additional inefficiencies be systematically higher in markets that are allocatively less efficient for other reasons? Indeed, the High-Level Group seemed to have quite the opposite mechanism in mind:[23] European securities markets are less integrated than their US counterparts and, therefore, cross-border takeovers are less frequent, leading to allocatively less efficient markets. Removing barriers to takeovers will facilitate economically beneficial takeovers by making them less costly. This leads to a higher occurrence of takeovers and brings about allocatively more efficient securities markets.

In contrast to golden share-type restrictions, however, shareholders themselves – either the existing shareholders of the target company or the bidder after the successful completion of his bid - can in principle remove statutory and contractual obstacles to takeovers. Whether a sufficient number of shareholders are willing to eliminate the barriers, e.g., statutory restrictions on the transfer of shares, and/or are willing to tender their shares to the bidder depends, other things being equal, on the price the bidder offers. If a break-through rule is in place, however, shares carrying control rights that deviate from the principle of "one share, one vote" will decrease in value and it will be less costly for a bidder to acquire a controlling stake in the company. Ultimately, thus, the break-through concept of the High-Level Group can be sketched as follows: in order to facilitate takeovers and to increase their occurrence control rights are to be redistributed among all holders of risk-bearing capital according to the principle of "one share, one vote" thereby making it less costly to acquire a controlling stake.

Upon closer inspection, however, this seemingly appealing concept becomes somewhat less obvious. Consider the following two numerical examples:

- Company X has issued 100,000 A shares with single voting rights that currently trade at 10 Euro, and 100,000 B shares with triple voting rights that currently trade at a premium of 20%. A bidder who wants to acquire a controlling stake, e.g., 75% of all voting rights, needs to buy only all of the Class B shares, i.e., 50% of all cash flow rights, at a price of 1,200,000 Euro. If a break-through rule were in place, however, he would have to buy all of the Class B shares and an additional 50 % of the Class A shares. Assuming an even redistribution of the control premium among the two share classes, the bidder would have to pay 1,650,000 Euro, but would now be acquiring a total of

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Smart/Zutter, Control as a motivation for underpricing: a comparison of dual- und single-class IPOs, Working Paper (download at www.ssrn.com), p. 5: by the late 1990s, about one in nine IPO firms adopted dual-class ownership, and those one in nine accounted for nearly 24% of aggregate IPO proceeds.

[23] See HLG Report (N. 1), p. 22.

75% of the cash flow rights. Clearly, whether the bidder would prefer to obtain control by acquiring shares with multiple voting rights or under the “one share, one vote” regime depends on the amount of private benefits the controlling shareholder is able to extract.

- Company X has issued 100,000 non-voting Class C shares that trade at 10 Euro and 100,000 Class D shares of common stock that currently trade at a premium of 20 %. Without a break-through rule in place, the bidder would only have to acquire 75% of the Class D shares at a price of 900,000 Euro; otherwise he would have to acquire all of class D shares as well as 50% of the Class C shares at a total price of 1,650,000 Euro. In the second case, the acquisition requires a much higher price – 1,650,000 Euro instead of 900,000 Euro - but the bidder also acquires a much higher percentage of residual cash flow rights - 75% instead of 37.5%. Again, the bidder‘s preference will, other things being equal, depend on the amount of private benefits a controlling shareholder is able to extract.

Both examples serve to illustrate a more general result:[24] from the perspective of a potential bidder the break-through rule does not necessarily work to his advantage. Whether he prefers to obtain control in a “one share, one vote” regime, i.e., the acquisition of a corresponding number of voting rights and cash flow rights, or instead by acquiring a comparatively higher number of voting rights, depends, inter alia, on his ability as a controlling shareholder to extract private benefits. Thus, depending on the quality of the respective corporate law regime and, in particular, on the protection of minority shareholders the introduction of a break-through rule might even lead to a lower instead of a higher probability of takeovers occurring.

On the other hand, this (potential) problem does not exist within the confines of a mandatory bid regime. Put differently, a mandatory bid rule requiring the bidder to extend the bid to several - or even to all - classes of risk-bearing securities eliminates the bidder‘s option to obtain control by acquiring a comparatively higher number of voting rights. At present, Art. 5 of the draft Takeover Directive requires that the mandatory bid be addressed only to all holders of securities, i.e., to all holders of transferable securities carrying voting rights (Art. 2 Para. 1 (e)).[25] The High-Level Group refrained from recommending an even further extension of the mandatory bid rule. Arguably, the inclusion of other classes of risk-bearing capital would make a bid more costly and, thus, would lower the probability of takeover bids.

The upshot of the preceding discussion is that the economic effects of a break-through concept are difficult to assess, at best. In order to compare a takeover regime without a break-through rule and a takeover regime based on the principle of “one share, one vote”, one would have

[24] For a more detailed discussion of the economic effects of the "one share, one vote"-element of the break-through rule see infra IV.2.c.

[25] This limitation is consistent with the scope of the break-through rule in Art. 11 that covers shares with multiple voting rights but not non-voting shares (Art. 11 Para. 5).

to calculate the costs and benefits of both designs. Apart from the relative change in takeover activity and the economic effects therefrom, one would also have to assess, for example, the effects that result from different possibilities for designing specific bundles of cash flow rights and voting rights. Given these difficulties the following sections will not undertake a comprehensive cost-benefit analysis of the break-through concept. Instead, they aim at reaching a more comprehensive assessment by separately analyzing the different components of the two guiding principles - shareholder decision-making and proportionality - and the corresponding elements of the break-through concept derived from them.

III. Shareholder Decision-Making

1. Shareholders as Exclusive Decision-Makers

The shareholders of a target company – and not its management – are to decide on the outcome of a takeover bid. This postulate translates into the duty of a board and its members to remain passive respectively neutral in the face of a bid. To be more precise, baring the search for competing bids, the board has to abstain from all actions that may result in the frustration of a bid (Art. 9 Para.2 of the draft Takeover Directive).

Right from the start, the rule of passivity has been a central feature of the successive proposals for a EU Takeover Directive. Furthermore, until very recently, the duty of passivity seemed to become the uniformly accepted regulatory standard for all EU Member States. The consensus among Member States, however, broke down in 2001 once the EU Parliament, on a tie vote, had failed to accept the then-current draft of the Takeover Directive. As is well known, the German legislator used this development to do away with the hitherto hardly disputed all-encompassing rule of passivity. Due to a last minute revision of the 2002 Act on the Acquisition of Securities and on Takeovers (Wertpapiererwerbs- und Übernahmegesetz), Sect. 31 Para. 1 of the Act requires only in principle that the management board takes no actions that may frustrate the bid and allows for three exceptions: (i) actions that a prudent and diligent manager of a company that is not affected by a takeover bid would have taken similarily, (ii) the search for competing bids, (iii) actions to which the supervisory board of the offeree company has consented[26]. This reorientation,

[26] For two reasons, there is still uncertainty as to the ambit of this exception to the rule of passivity. First, the exact scope of the supervisory board's competence to allow defensive measures is disputed. A good number of academics claim that the supervisory board can only authorize such measures that do not fall within the ambit of Sect. 33 Para. 2, i.e., if the shareholder meeting lacks the competence to authorize the defensive measure in question by way of a pre-bid resolution grounded in Sect. 33 Para. 2 (see, e.g., Bayer, Vorsorge- und präventive Abwehrmaßnahmen gegen feindliche Übernahmen, Zeitschrift für Gesellschafts- und Unternehmensrecht, 31 (2002), 588, 602, 6112 et seq.; Hirte, Verteidigung gegen Übernahmeangebote und Rechtsschutz des Aktionärs gegen die Verteidigung, Zeitschrift für Gesellschafts- und Unternehmensrecht, 31 (2002), 623, 640 et seq.; also in Hirte, in: same (ed.), Kölner Kommentar zum

however, only reflects the influence of German industry and German labor unions, not a changed perception of the drawbacks and doubtful merits of unilateral resistance of the target company's board, i.e., of defensive measures without shareholder authorization. On the contrary, occasional exceptions notwithstanding, academics have continued to support the principle of passivity as a sound policy for regulating board behavior in a takeover situation.[27]

Indeed, takeover regulation should not provide for unilateral defensive measures by the target company's board. Most participants in the extensive discussion on the benefits and drawbacks of defenses have explicitly or implicitly acknowledged that defenses can harm shareholders by increasing agency costs. This effect notwithstanding, some commentators have argued that defenses may also benefit shareholders for any or all of the three following reasons[28]: (i) Anti-takeover mechanisms may alleviate the pressure on shareholders to tender by allowing managers to block coercively designed bids; (ii) the availability of defensive measures improves the bargaining position of the target management's board and allows the board to negotiate with the bidder for a higher premium and/or to search for a competing bid; (iii) defensive measures may allow managers to prevent shareholders from accepting inadequate bid price offers in certain situations, i.e., if the mispricing results from general market myopia or from the target company undertaking projects the value of which is difficult to assess.

However, as argued elsewhere in considerable detail[29], none of these three arguments justifies a default rule to the effect that the target board is allowed to employ defensive measures without the prior authorization of shareholders once a bid to the target's shareholders is imminent or has already been launched. As a general policy guideline, takeover regulation, because of diversified investor portfolios and the beneficial disciplinary effects of the takeover threat, should not necessarily be geared towards maximizing takeover premia. Furthermore, even if one were to adhere to the contrary view, allowing managers to resist to a bid without shareholder authorization does not seem a wise policy given the severe agency problems in a takeover situation and the

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WpÜG, 2003, Sect. 33 N. 79 et seq.). Other commentators, most notably practitioners, are less restrictive arguing that the supervisory board can even authorize defensive measures that, in principle, could also be subject to a pre-bid authorization by the shareholder meeting (as to this debate, see the discussion report by Heinrich, Bericht über die Diskussion, Zeitschrift für Unternehmens- und Gesellschaftsrecht, 31 (2002), 659 et seq.). Second, even if one accepts the broader interpretation the supervisory board is still under a duty to act in the interests of the company as a whole ("Unternehmensinteresse") (see, i.e., Hirte, p. 642 et seq.; also in Hirte, Sect. 33 N. 84). Thus, the approval of any wealth destroying transaction is excluded per se. Among the rather short list of permissible measures the supervisory board will primarily consider using an authorized capital by way of excluding preemptive rights and, to a lesser degree, buying back own shares of the company.

[27] See Berglöf/Burkhart (N. 7), p. 33.

[28] For an overview, see, e.g., Coates, Explaining Variation in Takeover Defenses: Blame the Lawyers, California Law Review 89 (2001), 1301, 1329 et seq.

[29] As to the following, see Mülbert/Birke, In Defense of Passivity – on the Proper Role of a Target's Management in Response to a Hostile Tender Offer, European Business Organization Law Review 1 (2000), 567, 584 et seq., 589 et seq.

availability of other mechanisms that are less harmful to shareholders. To be more specific: For one, because of the unavailability of the flip-in poison pill as a defensive mechanism in EU Member States[30], managers may well have to resort to the type of wealth-destroying measures that were employed in the US before the introduction of the pill.[31] Moreover, from the European angle, the US solution to mitigate the conflict of interest between managers and shareholders in a takeover situation, i.e., the accelerated cash-out of high stock option-grants and/or other high severance payments may well be socially unacceptable or even illegal. In Germany, for example, Sect. 33 Para. 3 of the Act on the Acquisition of Securities and on Takeovers (Wertpapiererwerbs- und Übernahmegesetz) prohibits that the bidder, or any person acting in concert with him, grants unjustified benefits to any member of the target's boards in connection with the bid. Furthermore, on a more general level, Sect. 87 of the German Stock Corporation Act (Aktiengesetz) stipulates that the total compensation of management board members has to be appropriate in light of the tasks of the manager and the situation of the company. As of 21 May 2001, the Government Commission German Corporate Governance Code, giving in to popular demands in the press and governmental guidance by the German Ministry of Justice, even amended the German Corporate Governance Code to the effect that the supervisory board of a company shall determine a discretionary cap on stock options grants and comparable remuneration schemes for "extraordinary, unforeseen developments"[32]. Finally, even the pressure to tender target shareholders may experience does not warrant unilateral managerial resistance. All that would follow from accepting the premise of shareholders being subject to pressure to tender is that shareholders themselves should be allowed to resist takeover bids or to authorize target management to resist. Moreover, a mandatory full bid rule such as proposed in Art. 5 of the draft Takeover Directive would eliminate the threat of coercive bids by looters more effectively than allowing management resistance could ever do.

2. Post-Bid Shareholder Decision-Making

Shareholder decisions with respect to the outcome of a takeover bid are only relevant if shareholders decide after having received the bid, i.e., if they make their decision with full knowledge of the bid’s terms. This restriction precludes an ex ante authorization of management to take

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[30] See Government Commission German Corporate Governance Code, Press Release of 21 May 2003 (download at http://www.corporate-governance-code.de/eng/news/presse-20030521.html).

[31] As to this assessment, see <u>Gordon</u>, Das deutsche "Anti"-Übernahmegesetz aus US-Perspektive, AG 47 (2002), 670, 673.

[32] Pursuant to Art. 25 Para. 1 of the Second Directive (Official Journal L 26 of 31 January 1977; download at http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=31977L0091&model=guichett), the competence to decide on a raise of capital resides solely with the shareholder assembly and never with the board alone. As to the several decisions of the European Court of Justice reinforcing this rule, see, e.g., <u>Habersack</u>, Europäisches Gesellschaftsrecht, 2nd ed., München: Beck 2003, N. 187 et seq.

defensive actions as well as the application of statutory or contractual restrictions on the transferability in a takeover situation.

However, even before the recommendation of the High-Level Group many representatives of industry and some academics strongly argued in favor of allowing an anticipatory shareholder authorization of defensive actions.[33] In particular, the discussion in Germany prior to the enactment of the Act on the Acquisition of Securities and on Takeovers (Wertpapiererwerbs- und Übernahmegesetz) in its final stage almost exclusively centered on whether or not to allow the (in)famous "Ermächtigungsbeschlüsse“ respectively "Vorratsbeschlüsse“. As is well known, in the end, the German legislature provided for a hitherto unlawful form of shareholder resolution that, within the next 18 months, allows management to take certain actions that aim at frustrating the success of takeover bids (Sect. 33 Para. 2 of the Act).[34]

Opponents of this shareholder choice-model will point to the obvious danger that management will make use of such a "carte blanche“ even if such a course of action is disadvantageous to the present shareholders and only serves the interests of the managers. Proponents of this model might respond by questioning why the legislator should be concerned by such inefficient outcomes. After all, as owners of the company, shareholders are free to make decisions that are potentially detrimental to themselves, i.e., that allow management to frustrate a bid even if ex post shareholders will find it in their interest that management cannot interfere with the acceptance of the bid. In particular, the sole owner of a company could well state in advance his unconditional unwillingness to sell (sole owner standard). Furthermore, shareholders also benefit from the principle of private autonomy, i.e., within the general limits for private decision-making shareholders can make decisions even to their own disadvantage.[35]

The sole owner standard, however, does not go very far in justifying an ex ante shareholder authorization of defensive measures. As argued elsewhere,[36] a sole owner would not be bound by his own prior declaration. Given the favorable terms of an actual offer, he could still disregard his earlier statement and accept the offer. In contrast, allowing ex ante shareholder authorization of defensive measures would bind the shareholders insofar as they would have to repeal their former resolution in order to make sure that management would not interfere and prevent the shareholders

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[33] See, e.g., Uwe H. Schneider/Burgard, Übernahmeangebot und Konzerngründung – Zum Verhältnis von Übernahmerecht, Gesellschaftsrecht und Konzernrecht, Betrieb 54 (2001), 963, 968 et seq.
[34] For an overview, see Lohrmann/von Dryander, in: Apfelbacher/Barthelemess/Buhl/von Dryander, German Takeover Law – A Commentary, 2002, Sect. 33 N. 22 et seq.; for an in-depth analysis see Hirte, in: same (N. 26), Sect. 33 N. 95 et seq.
[35] See, e.g., McCahery, Commentary on The Draft Takeover Directive, p. 2 et seq. (download at www.europarl.eu.int/hearings/20030128/juri/mccahery.pdf).
[36] Mülbert/Birke (N. 29), p. 600.

from being able to accept the offer. Thus, even the sole owner standard requires that shareholders decide ex post in defending against a particular bid.

Upon closer inspection, even shareholder autonomy does not support an ex ante shareholder authorization of defensive measures. Obviously, management would have only to resort to a prior authorization of this kind if present shareholders, after having received a bid, were unwilling to allow defensive actions. Why, then, should the former majority of (past) shareholders be able to bind an unwilling majority of present shareholders with regard to an actual takeover bid? Proponents of the shareholder choice model fail to provide any convincing argument as to why company law should allow the majority of shareholders to protect their interests with regard to the ownership structure even after they have been reduced to a minority position. In particular, the pressure to tender-problem does not require the possibility of an ex ante authorization of defensive measures. Takeover law could sufficiently alleviate the pressure on shareholders to tender their shares to the bidder by providing for the possibility of a conditional acceptance, i.e., an acceptance on condition that the majority of shareholders unconditionally tender their shares.[37] Moreover, even if the bidder - in accordance with recommendation I.3 of the HLG Report - were allowed to vote on the shareholder resolution on defensive measures, minority protection by way of an ex ante authorization of defensive measures would not be justified or even required. The votes exercised by the bidder could, other things being equal, only lead to a different outcome from the former vote on the ex ante authorization of defensive measures if the bidder acquired his shares from one of the shareholders having voted in favour of the former authorization – which would mean that the former majority of shareholders had already been reduced to a minority position.

Admittedly, this line of reasoning might ultimately lead to the conclusion that the legislator should ban all pre-bid defensive structures created by shareholders that deter a takeover bid or make it less likely to occur. However, even if one does not embrace such a sweeping prohibition the rule of post-bid decision-making by shareholders still seems to be the appropriate solution. The fact that shareholders willingly buy into a company with pre-bid defensive structures in place does not allow any conclusions as to the rule shareholders would prefer in the face of a concrete bid. Given the severe agency problems in takeover situations shareholders would clearly prefer to

[37] Rules such as Sect. 16 Para. 2 of the German Act on the Acquisition of Securities and on Takeovers (Wertpapier-erwerbs- und Übernahmegesetz) achieve a similar effect by allowing shareholders that have not accepted the bid within the acceptance period to still tender their shares within a certain period. The HLG Report recommends a technically similar solution in the form of a sell-out right setting the threshold for triggering the sell-out right at the 90% level for each class of securities (recommendation III.1./4./5.). However, this class-by-class requirement flatly contradicts the Group's concept of including all risk-bearing securities on a proportional basis. Furthermore, a severe inconsistency exists between the 90% threshold triggering the sell-out right and the 75% threshold triggering the conversion of the company to a "one share one vote" regime. As an effective mechanism to alleviate the pressure to tender-problem the sell-out right would have to be triggered once the bidder obtains a majority of shares or, according to the concept of the HLG Group, a majority of all risk-bearing capital.

decide ex post on defensive measures unless they would substantially benefit from management acting independently from any actual shareholder authorization of defensive measures. However, it is hard to see, why this should be the case. In particular, even if the individual company in case is engaged in difficult-to-value projects shareholders would not decide on the outcome of the bid, i.e., would not be asked to evaluate the adequacy of the offer and react by either accepting or rejecting the offer. Instead, shareholders would only be called upon to decide whether to allow management to employ defensive actions, i.e., they would only need to evaluate whether the offer might be inadequate, and could leave any subsequent bargaining with the bidder to the management.

IV. Proportionality

1. Holders of Risk-Bearing Securities as Decision-Makers

The extension of the break-through concept to encompass all holders of risk-bearing securities has the effect that non-shareholders are vested with a partial voting right. This redefinition of minimum property rights attached to all residual cash flow rights will cause a number of market participants to adapt their holdings by buying or selling shares or other risk-bearing securities.[38] To this degree, the redistribution of voting rights is a costly measure and, if unnecessary, is to be avoided. Furthermore, there might be additional inefficiencies because of overprotection of some classes of risk-bearing securities or their holders.

Owners of residual cash flow rights are particularly vulnerable and prey to expropriation through opportunistic behavior by the company or its management. Thus, holders of such securities need some mechanism that enables them to protect their investment effectively. Jurisdictions within the EU are aware of two very different mechanisms to address this problem:
- the market-based solution, pursuant to which the (future) holder of a residual cash flow right enters into a contractual relationship with the company;
and
- the solution offered by company law proper, pursuant to which the holder becomes a member of the company and participates in the governance of the company by exercising the rights conferred on him as a member, e.g., by exercising his voting rights.

Given this dichotomy, the all-encompassing proportionality principle supported by the High-Level Group may well result in overprotecting some classes of risk-bearing securities. Owners of residual cash flow rights that can resort to market-based contractual arrangements to protect their

[38] In the following analysis all types of risk-bearing securities will be referred to as "shares".

investments do not need any additional voting right as a (quasi-)member of the company,[39] i.e., a voting right with respect to the authorization of defensive measures. On the other hand, any break-through rule ought to include owners of (preferred) non-voting stock who are entitled to exercise a vote in the shareholder assembly if the company defaults on the payment of dividends or other (preferential) rights. Clearly, these types of securities correspond to common stock insofar as company law provides for a vote as the fundamental protective mechanism. Thus, if the EU were to introduce the break-through concept, Art. 11 Para. 3 (and 2) of the proposed Takeover Directive should be amended to the effect that (preferred) non-voting stock be included as well.

Admittedly, the foregoing argument applies primarily to the participation in the voting on the shareholder authorization of defensive measures. However, all classes of securities that are entitled to vote on this authorization should be entitled to vote as well if the post-completion break-through rule were triggered, i.e., in a shareholder assembly held after the successful completion of the bid. Otherwise, minority shareholders that were unable to block the transfer of control to the bidder would in some cases still be in a position to prevent the bidder from exercising control. Again, if the EU were to introduce the break-through concept Art. 11 Para. 4 of the proposed Takeover Directive should be amended to the effect that (preferred) non-voting stock be included as well.

2. The "One Share, One Vote“ Voting Regime

a) General Observations

The takeover-specific application of the principle of "one share, one vote“ is clearly the most controversial part of the break-through concept recommended by the High-Level Group. Depending on the capital structure of the company and in particular the structure of its share classes this principle could lead to a fundamental redistribution of control rights once a bid for the company is made. Furthermore, while this shift would only temporarily affect the "normal“ distribution of voting rights with respect to the vote on the authorization of defensive measures,[40] the post-completion break-through rule would invariably lead to a permanent alteration of the original distribution of control, and in particular of voting rights. Admittedly, according to recommendation I.7 the shift of control should only persist for so long as the acquirer retains the relevant majority. However, upon acquisition of at least 75% of all "shares“, the acquirer – to

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[39] For a parallel position with regard to the scope of the mandatory bid see Baum, Vorzüge und Genussrechte in übernahmerechtlicher Sicht, Zeitschrift für Bankwirtschaft und Bankrecht 15 (2003), 9, 18 et seq.: the mandatory is to be addressed only to holders of securities carrying corporate law-specific membership rights.

[40] In one respect the Group advocates a permanent change already at the stage of the authorization of defensive measures. Holders of depository receipts of shares that represent risk-bearing capital should be free to exchange them for the underlying shares (HLG Report (N. 1), p. 28). That means, though, that the holders could keep the shares even if the bid were completely defeated or if less than 75% of all shares were tendered to the bidder.

remove any uncertainty and confusion amongst shareholders as to their position[41] - would be empowered to amend the articles of association and other constitutional documents to the effect that, in the future, he would be able to exercise controlling rights in accordance with his acquired stake of risk-bearing capital. Practically speaking, upon reaching the trigger threshold, the acquirer would, e.g., be entitled to abolish double and multiple voting rights as well as voting caps and to transform non-voting stock into common stock[42]. Presumably, he should even be entitled to abolish statutory provisions that grant holders of a special class of shares or third parties the right to make binding nominations for the appointment, suspension or dismissal of board members.

Clearly, the break-through concept would not prevent a shareholder from using his controlling block of voting rights to extract private benefits. Put differently, the level of private benefits extracted by shareholders is not affected by the break-through concept, but only determined by the quality of the applicable corporate law regime and, in particular, the rules for protecting minority shareholders. This observation holds true even if a company has been converted to the "one share one vote" regime following a successful takeover bid reaching the 75% threshold for triggering the transformation. Still, a successful bidder holding at least 75% of the residual cash flow rights will internalize more of the external effects that result from his extraction of private benefits. Thus, once the company has been converted to the "one share one vote" regime the external effects of a dual-class share structure will decrease. However, this internalization does not result from the break-through rule as such but from the high ownership level of residual cash flow rights set for triggering the transformation. Seen from this perspective, a mandatory full bid rule could even be more effective in causing a successful bidder to internalize the external effects stemming from his extraction of private benefits. Thus, the assessment of the "one share one vote" element on efficiency grounds warrants a somewhat broader discussion.

b) Legal Doctrine

So far, legal doctrine has treated the principle of "one share, -one vote" only in general terms, but not its takeover-specific application recommended by the High-Level Group. This is particularly true with regard to multiple voting rights, which the German legislature completely abolished in 1998. Earlier contributions by German legal scholars, as well as the discussion accompanying the 1998 law reform, however, illustrate that legal doctrin does not have much to say on policy questions, i.e., whether the legislator should tolerate or, on the contrary, should ban multiple voting rights – and by extension: of deviations from the principle of "one share, one

[41] HLG Report (N. 1), p. 35.
[42] In case of preferred non-voting stock presumably without conserving the preference right.

vote“.[43] Instead, for good reasons, legal doctrine focuses on the questions whether and, more importantly, how the legislator can abolish multiple voting rights without infringing on shareholders' fundamental rights.[44]

c) Economic Theory

(1) The mandatory break-through concept and, in particular, the post-completion break-through rule interferes with the market process. According to standard economic theory legislative intervention of this type is only called for in order to prevent a market failure. The failure targeted by the High-Level Group is a suboptimal level of Pan-European cross-border takeovers. At first glance, the existence of statutory and contractual barriers to takeovers - as opposed to golden share-type restrictions - will not hamper takeover activity. As shareholders themselves are able to do away with these "private“ barriers, such impediments will only work to the effect that the total amount to be paid by the bidder will be distributed differently among shareholders than under a "one share, -one vote" regime.[45] This amounts to saying that the structure of the share classes issued by the company – as opposed to its ownership structure – does not affect its total market value because all bidders are indifferent to the particular share class structure of a company. As discussed below, however, economic theory disagrees. Moreover, the redistribution of control rights intended by the break-through concept aims at raising the probability of takeovers by reallocating the control premium among shareholders and, thus, by lowering the total amount to be paid by the bidder.

(2) Given dual-class share structures, shares with superior voting power nearly always trade at a higher price than shares with lower or no voting power. Economists generally cite three arguments to explain the existence of a control premium: (i) the possibility of a controlling shareholder to extract private benefits; (ii) the expected future payment of a takeover premium; and (iii) other reasons. The third category comprises, inter alia, the observation that in some cases the cash flows accruing to the holders of different classes of shares differ over time.[46] The second explanation, despite its popularity, does nothing to explain the existence of a control premium but rather only begs a reformulation of the problem: why is a bidder willing to pay a control premium?

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[43] For an illustrative example see Zöllner/Noack, One share – one vote?, Aktiengesellschaft 36 (1991), p. 117, 118 et seq. (voting caps), 129 et seq. (multiple voting rights).

[44] For a short overview, see Dauner-Lieb/Lamandini (N. 3), p. 42 et seq.

[45] This at least true if the takeover regulation in place allows for price discrimination between the different classes of shares, e.g. between common stock with single and with multiple voting rights. Otherwise, i.e. if the bidder has to offer the highest price paid for any common stock or at minimum a certain percentage of this price, the effect of statutory or contractual takeover barriers becomes more difficult to evaluate. On the one hand, a highest price paid-rule will make bids more costly and, thus, lower takeover activity. On the other hand, stock prices may reflect reduced takeover activity respectively lower anticipated takeover premia. In the end, both effects may well cancel themselves out.

[46] Examples are provided, e.g., by Kunz, Was beeinflusst den Wert des Aktienstimmrechts?, Finanzmarkt und Portfolio Management 10 (1996), 330, 332.

The possibility for a controlling shareholder to extract private benefits, thus, turns out to be the pivotal explanation for the existence of control premia. Broadly speaking, private benefits comprise all pecuniary (gains from inequilibrate transfer prices etc.) and non-pecuniary (standing, etc.) advantages that - apart from dividend payments and other pro-rata distributions of the company's funds - accrue to a shareholder. Two types of private benefits deserve particular mention. Synergy gains on the part of the shareholder are special insofar as the company does not transfer any assets to him but receives no compensation for complying with his interests. Excessive management remuneration and other perquisites enjoyed by managers are special in case of managers being shareholders as well. Given this situation, lawyers tend to think in terms of private benefits extracted by the shareholder, whereas economists tend to think in terms of management entrenchment bolstered by a shareholding. Both perspectives are mutually compatible, though.

(3) The implications of private benefits for the principle of "one share, one vote" have been analyzed in a number of theoretical studies.[47] Their most relevant finding with respect to the present problem is that the existence of a dual-class share structure can be crucial if two types of bidders compete for (the management of) a company: bidder X, who manages the company's assets more efficiently and, thus, raises the future pro-rata cash flows to shareholders, and bidder Y, who, regardless of his ability to manage the company's assets more efficiently than incumbent management, is able to extract high private benefits. Given a dual-share class structure, bidder Y may be able to offer a higher bid premium for the higher voting shares and, thus, to acquire a majority of votes even if the additional value created by him – the higher value of the company plus the private benefits derived by him - is less than the higher company value that would result from a more efficient management of the company's assets by bidder X. A simple numerical example may illustrate the point: A company has issued 200 Class A shares with single voting rights and 101 Class B shares with double voting rights. Bidder X would increase the value of the company by 30 whereas bidder Y would be able to extract private benefits in the amount of 9. Bidder Y could out compete bidder X in a bid for all of the Class B shares and, thus, for control of the company as long as bidder Y were able to increase the value of the company by at least 6.

The intuition behind this somewhat surprising result is easy to understand. X is a pure value-enhancing bidder. At the margin, she can offer a bid premium for Class B shares that equals the additional discounted future cash flows per share generated by her more efficient management of the company`s assets. In contrast, Y can use all of his private benefits in order to compete for the

[47] See, e.g., Grossmann/Hart, One share-one vote and the market for corporate control, Journal of Financial Economics 20 (1988), 175 et seq.; Harris/Raviv, Corporate Governance, Journal of Financial Economics 20 (1988), 203 et seq.; same, The Design of Securities, Journal of Financial Economics 24 (1989), 255 et seq.; cf. Burkart/Gromb/Panunzi, Why Higher Takeover Premia Protect Minority Shareholders, Journal of Political Economy 106 (1988), 172 et seq.

higher-voting Class B shares. Thus, if there are some private benefits, a type-Y bidder can offer a higher premium for the controlling share class even if he were to manage the company's assets (far) less efficient than a competing pure value-enhancing bidder.

Against this background, the effect of the "one share, one vote"-element of the break-through rule is easy to discern. It serves to enhance the competitive position of type-X bidders relative to type-Y bidders. With a break-through rule in place, both types of bidders would have to acquire a higher number of shares in order to obtain control than without such a rule. This alteration of the takeover regime would not affect the marginal bid premium paid by bidder X. Bidder Y, however, would experience a decreasing marginal bid premium because he would have to use constant private benefits to buy more shares. Thus, while the "one share, one vote"-element does not assure social optimality (in the sense that the company's assets are always managed by the most efficient user) the break-through rule would go some way towards this goal. Put differently, a break-through rule on the basis of "one share, one vote" could be credited with increasing allocative efficiency.

(4) Within the framework of a mandatory full bid rule - a central feature of the successive proposals for an EU Takeover Directive now contained in Art. 5[48] with respect to shares carrying voting rights – the preceding analysis in favor of a break-through rule on the basis of "one share, one vote" looses its persuasive power. The reason is straightforward: the mandatory full bid rule not only improves the competitive position of pure value-enhancing bidders but even puts the two types of bidders on an equal footing. If a bidder acquires all of a company's shares, he fully internalizes the externalities caused by his extracting private benefits at the expense of the company and its shareholders, respectively. Thus, with respect to both bidders, their marginal bid premium is solely determined by the additional value they can create by managing the company's assets: additional value of the company (type-X bidder) vs. additional value of the company plus private benefits (type-Y bidder). Put differently, even without a break-through rule in place, the mandatory full bid rule assures that the more efficient user will manage the company' s assets.

[48] To be sure, Art. 5 of the draft Takeover Directive does not require the bidder to launch a single full bid. However, if the bidder obtains control due to a partial bid he has to launch a second bid, i.e., the mandatory bid, for all outstanding shares. So far, the draft Directive only provides for one exception to the mandatory full bid requirement: Pursuant to Art. 5 Para. 2, the bidder is exempt from having to make a mandatory bid if he obtains control following a voluntary bid made in accordance with the Directive, and in particular in accordance with the equitable price requirement, to all holders of voting shares for all their holdings. However, the mandatory bid rule regimes already in place in different Member States provide for various additional exceptions (see, e.g., Sect. 36 (excluding voting rights from determining whether the control threshold has been reached) and Sect. 37 (exemption from the bid requirement) of the German Act on the Acquisition of Securities and on Takeovers). To avoid any uncertainty with respect to the implementation of the Directive the EU legislator should incorporate a provision delineating the possible scope for exceptions. So far, Member States, in implementing the Directive, could provide for additional exceptions only by arguing that "the Directive itself does not attempt to specify the percentage of voting rights above which control can be deemed to have been acquired or the method of calculating such a percentage" (Commission Communication (N. 2), p. 7).

Arguably, the bidder could try to mitigate this effect somewhat by offering a low enough bid price designed to attract as few shares as necessary to acquire a majority.[49] The minimum price requirement in Art. 5 Para. 1, 4 of the draft Takeover Directive – pursuant to Para. 4 the bidder has to offer an equitable price - renders this strategy at times difficult to implement, however. Furthermore, this strategy could only work in the absence of a rival bidder. Otherwise, competition between the two bidders would eliminate any chance of choosing a bid price to the effect that only the lowest number of shares required will be tendered to the bidder. However, with respect to a break-through rule based on "one share, one vote", the possible benefits identified so far also depend on the existence of a rival bidder.[50]

A caveat is necessary, however. The just described effect of a mandatory full bid regime only holds true if, given a dual-class share structure, the mandatory bid rule extends to all share classes. Thus, in order to create a truly level playing field between the different types of bidders, Art. 5 of the draft Takeover Directive should be amended to the effect that the mandatory offer is to be addressed to the holders of non-voting shares as well, and preferably even to holders of non-voting shares carrying specific pecuniary advantages.

(5) Given a mandatory full bid regime (Art. 5 of the draft Takeover Directive), the introduction of a break-through rule based on "one share, one vote" is sometimes said to lead to severe inconsistencies.[51] According to these critics, while the mandatory bid rule aims at distributing some of the private benefits of control to minority shareholders, the break-through rule conversely results in minimizing the control premium attached to higher-voting shares.

Obviously, this argument implicitly assumes the absence of a rival bidder. However, the incumbent holder of the higher-voting shares, in particular, is a (potential) rival unless the bidder acts in accordance with him. If the incumbent values his private benefits higher than the control premium offered by a third bidder he can protect his controlling position by making a counter-offer in order to prevent a switch from the dual-class voting regime to "one share, one vote". Thus, given a mandatory full bid regime the break-through rule would only deprive minority shareholders of a

[49] In particular, Burkart/Gromb/Panunzi (N. 47) heavily rely on this idea.
[50] For analytical purposes, the presence of a rival bidder does not require that a bidder contest actually does take place. All incumbents, e.g., a controlling shareholder, that derive private benefits can be conceptualized as (potential) rivals that will consider fending off a competing bid in order to protect their privileges. In reality, though, incumbents may suffer from liquidity constraints and, as a consequence, may not be able to make a competing offer. This particular problem will be addressed in a moment.
[51] Berglöf/Burkhart (N. 7), p. 34; McCahery (N. 30), p. 4.

higher control premium if the incumbent controlling shareholder suffered from liquidity constraints.[52]

On a more fundamental note, the decrease of the control premium, as a consequence of the break-through rule, is not an effect to take issue with. As already mentioned in Section IV.1, the maximization of takeover premia should not be among the objectives of takeover regulation policy. Proponents of bid premia maximization sometimes claim, however, that the ex ante premium maximization results in better ex post protection of remaining minority shareholders. Basically, they argue as follows:[53] A higher premium leads to the ex ante tender of more shares. Because of the resulting higher concentration of shareholdings the acquirer will internalize more of the externalities that result from his extraction of private benefits. In turn, this decrease in externalities will lead to a higher ex post share price. Upon closer inspection, however, this argument is flawed. While it is true that a higher concentration of shareholdings lowers the external effects due to the extraction of private benefits, the number of outstanding shares does decrease as well. Put differently, regardless of the number of shares acquired by the new controlling shareholder, per share, the external effect of private benefits remains constant. Thus, the amount of the bid premium and, in turn, the number of shares tendered does not affect the post-bid share price.

On the other hand, the reallocation of the control premium for higher-voting shares would only facilitate takeovers if the bidder, as a consequence of the dilution, could save on the amount of compensation he had to pay for all shares. The total amount to be paid crucially depends on the minimum price rule prescribed by the mandatory bid regime; i.e., on the reading of the equitable price rule contained in Art. 5 of the draft Takeover Directive. The dilution of the premium would not affect the amount to be paid for all shares if the rule allowed for price discrimination among the different share classes, e.g., among common stock with single voting rights and with multiple voting rights.[54] Conversely, the allocative effect of a break-through rule based on "one share, one vote" had a beneficial impact on takeover incidence if the minimum bid price for all shares was determined by the highest price paid for any class of shares.

V. Concluding Remarks

The all-encompassing break-through concept as developed by the High-Level Group consists of four core elements. Three of these are essential to the concept: exclusive shareholder decision-making, post-bid shareholder decision-making, and shareholder voting based on "one share, one

[52] See Berglöf/Burkhart (N. 7), p. 26 et seq., 34.
[53] See Burkart/Gromb/Panunzi (N. 47), p. 174.
[54] According to Arnold, Mehrstimmrechte und stimmrechtslose Vorzugsaktien in der Übernahmerichtlinie, Der Konzern 1 (2003), 173, 176, Art. 5 of the draft Takeover Directive allows for bid price discrimination.

vote". The fourth element – decision-making by all holders of risk-bearing securities – is expendable and, as a corollary, most difficult to defend. On the other hand, the narrow restriction of the draft Takeover Directive to transferable securities carrying voting rights in the company (Art. 2 Para. 1 lit. e) appears inadequate. At a minimum, ordinary non-voting shares should be included as well. Furthermore, non-voting shares carrying specific pecuniary advantages should at least be included if, as a consequence of a series of non-payments of preferential rights, shareholders obtained a voting right.

The preceding analysis of the essential elements of the break-through concept has shown that the High-Level Group chose the appropriate starting point: the principle of shareholder decision-making. Shareholders – not managers – should decide on the fate of a bid, and they should only decide in full knowledge of the terms of an offer or, at the very least, in full knowledge that a concrete bid is imminent. The draft Takeover Directive adequately reflects this principle by banning any ex ante shareholder authorization of defensive measures (Art. 9). Furthermore, Art. 11 Para. 2, pursuant to which statutory and contractual restrictions on the transfer of securities are (only) unenforceable for the purpose of a shareholder vote on defensive measures, points in the right direction, at least.

"One share, one vote" shareholder voting in the takeover-related context is the key innovative feature of the break-through concept. For the concept to work, the "one share, one vote" regime must apply to the vote on defensive measures as well as to all shareholder decision-making after the successful completion of the bid. That means that the company's voting regime must change permanently to "one share, one vote" once the bidder holds shares in excess of a certain trigger threshold, i.e., the 75% threshold recommended by the High-Level Group. Given the mandatory full bid regime in Art. 5 of the draft Takeover Directive, however, the effects of a break-through rule based on "one share, one vote" are confined to diluting the control premium attached to higher-voting shares. Furthermore, this dilution would only facilitate takeovers if, as a consequence, the total amount to be paid by the acquirer were lower. This, in turn, depends on whether the minimum share price prescribed by the mandatory bid rule allows for price discrimination among the different share classes.

In all, the economic analysis presented in this paper supports the view that there is no need for European takeover regulation to incorporate an all-encompassing break-through concept based on "one share, one vote". On the other hand, apart from raising some difficult new problems – compensation (?) of holders of higher-voting shares;[55] adequate legal treatment of holding pyramids

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[55] One may doubt whether EU law requires that the holders of higher-voting shares, and in particular the holders of shares with double or multiple voting rights, are compensated for the loss of a control premium if the said financial

– the foregoing analysis did not identify any compelling argument against the introduction of such a rule either. In particular, the EU legislator should not be concerned by the possibility that some incumbent controlling shareholders may be financially constrained and, thus, may not be able to launch a counter-offer in order to protect their private benefits of control. At any rate, however, the legislator should clarify Art. 5 of the draft Takeover Directive to the effect that, for the purpose of fixing the minimum share price to be offered, the equitable price for each class of shares is to be determined independently.

Finally, even at the time of completing this paper, the future fate of EU takeover regulation remains unclear. This holds true for the break-through concept (Art. 11) as well as for board neutrality (Art. 9) as its "twin" (on the political agenda, not in substance!), and even for the draft Takeover Directive as a whole. Thus, it remains to be seen whether the break-through rule dead-ends all efforts of introducing a European takeover regulation or, on the contrary, acts as a catalyst that enables the EU finally to break through to the adoption of a Takeover Directive. Even if the EU would fail to reach this major break through in the creation of a Pan-European level playing field the HLG Group ought to be credited with having paved the way to a mini break through: Without the intervention of the break-through concept the Takeover Directive would not have returned to the agenda of the European legislator.

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advantage can be traced back to the ability of a controlling shareholder to extract private benefits at the expense of the company and other shareholders, respectively. But see Arnold, Entschädigung von Mehrstimmrechten nach § 5 EGAktG, Deutsches Steuerrecht 41 (2003), 784, 785: private benefits in the form of synergy gains are to be compensated (with respect to German law).

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