Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of US and UK Takeover Regulation.

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Preliminary version: January 25, 2006.

Abstract

Hostile takeovers are commonly thought to play a key role in rendering managers accountable to dispersed shareholders in the 'Anglo-American' system of corporate governance. Yet surprisingly little attention has been paid to the very significant differences in takeover regulation between the two most prominent jurisdictions. In the UK, defensive tactics by target managers are prohibited, whereas Delaware law gives managers a good deal of room to maneuver. Existing accounts of this difference focus on alleged pathologies in competitive federalism in the US. In contrast, we focus on the 'supply-side' of rule production, by examining the evolution of the two regimes from a public choice perspective. We suggest that the *content* of the rules has been crucially influenced by differences in the *mode* of regulation. In the UK, self-regulation of takeovers has led to a regime largely driven by the interests of institutional investors, whereas the dynamics of judicial law-making in the US have made it relatively difficult for shareholders to influence the rules. Moreover, it was never possible for Wall Street to 'privatize' takeovers in the same way as the City of London, because US federal regulation in the '30s both pre-empted self-regulation and restricted the ability of institutional investors to coordinate.

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We are most grateful to Christopher Daniels, Julian Francis, Peter Lee and Noel Hinton for meeting with us to discuss the history of the Panel on Takeovers and Mergers, and we are heavily indebted to Jay Verjee for his outstanding research assistance on this topic. We thank Brian Cheffins, Sean Griffith, Richard Nolan, Mathias Siems, Michael Wachter […] for their comments on drafts and participants in seminar presentations (12th Comparative Law & Economics Forum in Chicago, the University of Pennsylvania Law School Faculty Retreat, the Law, Finance and Development workshop in Cambridge and the Sloan/Anton Phillips Conference on International Financial Markets and Corporate Governance at Georgetown Law Center) for helpful discussions. We gratefully acknowledge funding from the ESRC and the Yorke Fund (Armour) and the University of Pennsylvania Law School (Skeel). The usual disclaimers apply.

'More rubbish than wisdom has been talked about takeover bids.'[1]

I. INTRODUCTION

A distinguishing feature of the so-called 'Anglo-American' system of corporate governance is that share ownership in public corporations is dispersed. A key mechanism for rendering managers accountable to shareholders is the market for corporate control: namely, the threat that if the managers fail to maximise the share price, the company may become an acquisition target. Given that this mechanism is thought to be pivotal to making dispersed ownership viable, it is strange that so little attention has been paid to the very significant differences in the way in which takeovers are regulated *between* the two systems that together comprise the 'Anglo-American model'. Both the *mode* and the *substance* of the regulation are quite different.

In the UK, takeovers are regulated by the City Code on Takeovers and Mergers, a self-regulatory code that is administered by the Panel on Takeovers and Mergers. Staffed by personnel on secondment from the professional community that it regulates, and untrammelled by the procedural and precedential niceties of the courtroom, the Panel is able to respond in a flexible and well-informed fashion to disputes and govern their resolution in 'real time'. In contrast, most US takeovers are governed by the courts of Delaware. Whilst as courts go, these are quick and flexible, they nevertheless tend to lend an *ex post* flavour to dispute resolution.

The content of takeover regulation also differs markedly across the Atlantic. In the UK, the Code is strongly weighted towards protecting the interests of shareholders. Coercive bids are outlawed by the equal treatment and mandatory bid requirements. Moreover, any defensive tactics employed by management—without shareholder consent—which would have the effect of frustrating an actual or anticipated bid are strictly prohibited by the Code. In contrast, management in the US have a good deal more flexibility to engage in defensive tactics, provided that these can be justified in accordance with their fiduciary duties.

[1] ECONOMIST, Oct 31 1959, 140.

This set of differences raises a number of interesting questions. First, how are the divergences between these two superficially similar systems to be explained? At the level of substance, what leads Delaware's jurisprudence to be so much friendlier to managers than the British City Code? Some scholars assert that it flows from the dynamics of competitive federalism in the US. In an environment characterized by regulatory competition, the winning 'product'—that is, Delaware law—will reflect the preferences of the group which do the 'buying'. In the view of Bebchuk and others, the managers of listed corporations have undue influence over the choice of corporate governing law, and hence, it has tended to favour their cause in takeovers.

In contrast, our account does not require an assumption that US managers have effective control over choice of corporate law—the veracity of which is, of course, a hotly contested question. Rather, we suggest that the *mode* of regulation has been a crucial influence on its *substance*. The British case, the history of which we chart through interviews with participants and contemporary newspaper sources, is relatively easy to understand. Here, the self-regulatory system was orchestrated principally by the community of investment bankers and institutional investors. Corporate managers were not a well-organised constituency, and had little say in the formulation of the regulation. Hence it is hardly surprising that the rules were designed to protect the interests of shareholders. In the US, on the other hand, the development of the rules depends upon the accumulation of common law precedents. The crucial point to understand here is that judges can only decide the cases which are brought before them—thus, the evolution of the common law depends upon the incentives parties have to litigate as opposed to settle disputes. Public choice analysis can be applied to common law precedent-production, just as to legislation. Where particular groups of litigants are better-organised or funded than others, the content of the law may be expected, over time, to develop in a manner favourable to their interests. In litigation over takeover disputes, directors have just such an advantage, because of the collective action problems facing shareholder litigants. This claim, it should be understood, is not one about Delaware so much as the common law—and it is buttressed by noting that the content of English law on the subject—which governed before the matter was 'privatised' by the advent of the City Code in the late 60s—is similarly manager-friendly.

This leads naturally to a related question: if the substance of the regulation is determined by its mode, how in turn are the differences in process to be explained? In London, City professionals—in particular, institutional investors—were able to avoid the need for *ex post* litigation by developing a body of norms, enforced by reputational sanctions, which ensured that contentious issues were resolved *ex ante* without the need for court involvement. Why is it that self-regulation never took hold in Wall Street in the same way? At first blush, the answer might seem to be simply that retail investors account for a much more significant proportion of stock ownership in the US than the UK, and consequently US institutional investors have never risen to own a similar proportion of listed stock as have their UK counterparts. As a result, co-ordination is less worthwhile for such investors and self-regulation is less likely to emerge.

Such a story, however, misses what we believe to be the crucial role of law in structuring these developments. As Mark Roe and others have described,[2] US federal regulation in the '30s and before restricted both the scale and the scope of services that financial institutions were permitted to provide, crucially undermining the ability of institutional investors to coordinate. This led not only to the relatively high incidence of retail investors, but also to an environment which was hostile to self-regulation. Indeed, the same federal legislation directly prohibited the NYSE from seeking to regulate a range of activities that have fallen within the purview of 'soft law' in London. At the same time, restrictive personal taxation in the UK, coupled with a safe harbour for pensions, greatly accelerated the development of collective investment vehicles. Thus in our view, the UK's self-regulatory system was driven by the preponderance of institutional investors in the marketplace, and a regulatory framework that trusted them to govern themselves; whereas the US was characterised by many more retail investors and a popular mistrust of the 'insiders' who controlled the financial institutions, reflected in the latter's being kept for so long on a tight regulatory leash.

These issues of regulatory development raise a normative question: can we say that one system has properties that make it preferable to the other? Little attention has to date been paid to

[2] See MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); Bernard S. Black and John C. Coffee, *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation* 92 MICHIGAN L. REV. 1997 (1994).

the question of which mode of regulation is preferable. We consider that the UK's system has *prima facie* advantages in terms of procedure—it seems at once quicker, cheaper, and more certain than a system which relies upon litigation. Turning to substance, much ink has of course been spilled on the question of whether, and to what extent, defensive tactics should be permissible in the face of a hostile bid. We consider that the City Code's 'no frustrating action' rule is likely to be preferable, whilst recognising that the state of the empirical literature is such that the claim cannot be made emphatically.

Our account of the differences in the development of the two systems suggests that the choice of rule-maker—judges or self-regulatory bodies in this instance—can be just as important an influence on the substance of takeover law as can be regulatory competition. This has important implications for the future development of European takeover law, where issues of competitive federalism are starting to become much more pertinent on the other side of the Atlantic in the light of the *Inspire Art* ruling and the passing of the pro-choice Thirteenth Company Law Directive.

The rest of this paper is structured as follows. Section II describes the differences between the US and UK systems of takeover regulation. Section III gives a historical account of their development. The reasons for their divergence are explored in Section IV, and Section V offers a comparative evaluation of the present position. Section VI considers the implications for the future of EU takeover law, and Section VII concludes.

II. TWO DIFFERENT MODES OF TAKEOVER REGULATION

Hostile takeovers are the nuclear threat of corporate law, the most dramatic of all corporate governance devices. A properly functioning takeover market enhances corporate governance in two related ways. If the bidder brings in better managers after the bid, or can improve the target's performance by reconfiguring its assets or exploiting synergies between the two firms, there is a direct, cause-and-effect relationship between the takeover and firm value. Takeovers have a second, indirect benefit as well. If managers have reason to suspect that a hostile bidder

will swoop in and take control if they run the company badly, the prospect of a takeover can keep the managers on their toes.

For over twenty-five years, academics have debated the question of how best to regulate the takeover market. The-more-the-merrier, argued Frank Easterbrook and Dan Fischel. Their passivity thesis proposed that managers be prohibited from defending against a takeover, so that the company's shareholders would be the ones who decided whether to accept the bid.[3] If the decision were left to target's managers, the managers' interest in preserving their own jobs would too often overcome their fidelity to the best interests of the company. In response, other commentators argued that managers should be given at least some scope to slow down an initial takeover bid. On this view, managers should be permitted to defend against a takeover to the extent necessary to get the best possible price for the company's shareholders.

In the United States, Easterbrook and Fischel's shareholder-oriented approach has been far more successful in theoretical debates than as an influence on actual practice. The Delaware courts have dismissed the shareholder choice perspective in several important takeover decisions, emphasizing instead that the company is managed by or under the control of its directors.[4] If we look across the Atlantic, by contrast, we see a remarkably different picture. The UK has explicitly rejected managerial discretion in favor of the shareholder-oriented strategy for regulating takeovers. At least as important, the *mode* of takeover regulation also looks quite different in the UK than in the US. Before trying to make sense of the divergent regimes, we need to consider both the principal differences between the two approaches, and where as a historical matter these differences came from.

A) <u>The Substantive Contours of Takeover Regulation</u>

Start with the substantive terms– the "what"– of takeover regulation. United States

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[3] Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

[4] Footnote 14 of one of Delaware's most pro-takeover decisions, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173 (Del. 1985), for instance, is at pains to disclaim the Easterbrook and Fischel perspective, emphasizing that "we do not embrace the passivity thesis rejected in *Unocal*.

regulation gives a bidder complete flexibility to bid for as small or as large a percentage of the target company's stock as they wish. US law has never imposed a "mandatory bid" rule requiring bidders who acquire a large block of target shares to make an offer for all of the target company's shares. US tender offer regulation does require, however, that the bidder pay the same price for all of the shares it acquires; that the bidder purchase a pro rata amount of the shares of each shareholder who tenders her shares; and that it keep the bid open for at least twenty days.[5] The US regulations thus protect shareholders against so-called "Saturday Night special" bids that were kept open only for a short time and made available only to the first shareholders who tendered in order to create pressure on shareholders to rush to tender. But they do not guarantee shareholders that they will be able to sell all of their shares if a bidder takes control of the company.[6]

While US regulation of tender offer bidders is quite shareholder-friendly, the treatment of target managers' responsibilities in the face of an unwanted takeover bid is anything but. Managers of a target company are permitted to use a wide variety of defenses to keep takeover bids at bay. The most remarkable of the defenses is the poison pill or shareholder rights plan, which is designed to dilute a hostile bidder's stake massively if the bidder acquires more than a specified percentage of target stock– usually 10 or 15%. Poison pills achieve this effect– or more accurately, would if they were ever triggered– by, amongst other things, inviting all of the target's shareholders except the bidder to buy two shares of stock for the price of one. The managers of a company that has both a poison pill and a staggered board of directors have almost complete discretion to resist an unwanted takeover bid.[7] In addition to poison pills and staggered

[5] The principal US tender offer regulations were enacted in connection with the 1968 Williams Act, which amended the Securities and Exchange Act of 1934. For a brief summary of the regulations, see MELVIN A. EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 1136-40 (8th ed. Unabridged 2000).

[6] As noted below, eschewing a mandatory bid rule can be seen as shareholder friendly, even though it means that some of each shareholder's shares may not be acquired, because mandatory bid rules have a chilling effort on takeovers. See *infra*, text to nn ??-??.

[7] This point is made forcefully in Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885 (2002).

boards, US targets are also permitted other defenses, such as breakup fees and other "lockup" provisions that are designed to cement a deal with a favored bidder while keeping hostile bidders at bay.[8]

However, the discretion vested in target managers is not absolute. They are sometimes required to remove takeover defenses, as when the managers tilt the playing field toward one bidder in the heat of an actively contested takeover battle. But target bidders have extensive discretion– particularly if they wish to "just say no" to any bid for to acquire the company.[9] Moreover, nearly every state has enacted antitakeover legislation that is designed to slow down unwanted takeovers.[10] Under Pennsylvania's antitakeover law, for instance, managers are permitted to take non-shareholder interests into account; bidders lose their voting rights unless the remaining shareholders vote to reinstate the rights; and bidders are subject to "fair price" provisions if they acquire control of the company.[11]

In contrast to the US, UK takeover regulation has a strikingly shareholder-oriented cast. The most startling difference comes in the context of takeover defenses. Unlike their US brethren, UK managers are not permitted to take any "frustrating action" once a takeover bid has materialised. Poison pills are strictly forbidden, and so is any other defense that will have the effect of impeding target shareholders' ability to decide on the merits of a takeover offer, such

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[8] *See, e.g.,* David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lockups*, 90 NW. U.L. REV. 564 (1996).

[9] Although the Delaware Supreme Court has never explicitly endorsed the "just say no" approach, and there are hints that the Delaware Chancery Court may reject it, at least for target companies that have both a staggered board and a poison pill, target managers are seen as having broad discretion to defend against an unwanted takeover bid.

[10] The first generation of state antitakeover statutes was struck down in *Edgar v. MITE* Corp.*,* 457 U.S. 624 (1982), largely because they purported to govern any corporation doing business in the state. States' lawmakers subsequently revised their antitakeover statutes to apply only to companies incorporated in the state. The second generation statutes were upheld in *CTS Corp. V. Dynamics Corp, of America*, 481 U.S. 69 (1987).

[11] Under a fair price provision, a bidder who acquires less than 100% of the stock and wishes to eliminate minority shareholders through a cash out merger after acquiring control is required to pay as much to the minority shareholders as in the original acquisition. The principal difference between a fair price provision and a mandatory bid rule is that the bidder is not obligated to offer to buy the minority shares.

as buying or selling stock to interfere with a bid, or agreeing to a lockup provision with a favored bidder.[12]

The tender offer requirements are largely consistent with the goal of giving shareholders an unfettered choice whether to accept or reject a takeover bid. As in the US, bidders are subject to an equal treatment rule that requires them to pay the same price to everyone who tenders into a tender offer. Almost the only provision that can be viewed as discouraging takeovers is the UK's mandatory bid requirement. The mandatory bid provision requires a bidder who acquires thirty percent or more of a company's stock to keep going, and to make an offer for all of the stock. In effect, this prohibits partial bids, and thus chills at least some takeover offers by forcing bidders to raise enough money to acquire the entire company.

To be sure, the UK's City Code only becomes relevant when a bid is on the horizon. Up to that point, managers' conduct is regulated by a combination of their common law fiduciary duties and the UK Listing Rules. It might be thought that managers seeking to entrench themselves would take advantage of this less stringent *ex ante* regulation to "embed" takeover defenses well before any bid comes to light.[13] Such "embedded defenses" could range from the fairly transparent, such as the issue of dual class voting stock, the use of "golden shares" or generous golden parachute provisions for managers, to the more deeply embedded, such as provisions in bond issues or licensing agreements for acceleration or termination on a change of control.

Yet in practice such defenses are rarely observed on anything like the scale that they occur in the US. This is partly because of various other aspects of the UK's corporate governance environment, which restrict directors' ability to entrench themselves. For example, English company law requires directors are required by company law to seek approval from the

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[12] See generally, WEINBERG & BLANK, Section 20.

[13] Richard E. Kihlstrom & Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law,* 152 PA. L. REV. 523 (2003); Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. Pa. L. Rev. 577 (2003).

general meeting for authority to issue new shares,[14] and in listed companies this will usually only be granted subject to guidelines formalised by institutional investors.[15] Dual class voting stock, whilst not directly prohibited, is strongly frowned upon by institutional investors,[16] to the extent that a company which seeks to issue it will suffer a severe price penalty in raising capital.[17] In addition, pre-emption rules provide that directors must offer any new shares first to existing shareholders *pro rata* with their holdings.[18] Moreover, a combination of provisions[19] have reduced the extent to which 'golden parachute' provisions in executive service contracts can entrench managers.[20]

Overall, then, UK takeover law is far more shareholder-oriented than the rules in place in the US. This is reflected in the empirical evidence on the frequency of bids. Completed takeovers in the UK account for a larger share of the country's GDP than do those in the US.[21]

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[14] Companies Act 1985 s 80.

[15] See ASSOCIATION OF BRITISH INSURERS, GUIDANCE ON DIRECTORS' POWERS TO ALLOTT SHARE CAPITAL AND DISAPPLY SHAREHOLDERS' PRE-EMPTION RIGHTS (May 1995).

[16] G.P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE (OXFORD: OUP, 1996), 58-59; WEINBERG & BLANK, 4-7077 (noting rarity of dual-class issues and a number of instances where proposals to issue dual-class shares have been dropped following hostility from institutional investors).

[17] For example, non-voting shares typically trade at a discount of 10-20%: WEINBERG & BLANK, 4-7073.

[18] UK Listing Rules, rr. 4.16-4.21. The Companies Act 1985 also provides a pre-emption rights regime (ss. 89-96), but the protection for investors found in the Listing Rules is stronger: see Eilís Ferran, 'Legal Capital Rules and Modern Securities Markets—the Case for Reform, as Illustrated by the UK Equity Markets' in K. HOPT AND E. WYMEERSCH (eds.), CAPITAL MARKETS AND COMPANY LAW (OXFORD: OUP, 2003), 115, 131-33. The pre-emption rights regime may be relaxed with shareholder approval, but institutional investor guidelines provide that this will only be granted in limited circumstances: ASSOCIATION OF BRITISH INSURERS, PRE-EMPTION GROUP GUIDELINES (October 1987).

[19] Companies Act 1985 s 234A, 241A and Sch 7A, introduced by Directors' Remuneration Report Regulations 2002 (requiring annual publication by listed companies of detailed report on directors' remuneration and precatory vote by general meeting on its contents).

[20] STAPLEDON, INSTITUTIONAL SHAREHOLDERS, 73-76; Combined Code 2003, Para B.1.7 (notice period of directors' service contracts should usually be no more than one year).

[21] Rossi and Volpin report statistics on the *rate* of takeover activity across countries durign the period 1990-

Perhaps most significantly for our purposes, hostile bids are far more likely to succeed in the UK than the US.[22] As the authors of *The Anatomy of Corporate Law*, a prominent new book on comparative corporate law, put it, "[d]espite the commonality of the issue, the UK and the US have made almost diametrically opposed choices" on how to regulate hostile takeovers.[23]

B) The Divergent Modes of Regulation

The differences in the mode of takeover regulation are, if anything, even more striking than the substantive differences between the two nations' regulatory regimes.

Start once again with the US. US takeover regulation is the domain of courts and regulators. The tender offer itself is regulated by the Securities and Exchange Commission, which assesses compliance with the disclosure and process rules. Managers' response to a takeover bid, by contrast, is regulated primarily by state courts– which usually means Delaware's chancery judges and Supreme Court. When a takeover bidder believes that the target's managers are improperly stymying its bid, the bidder generally files suit in the Delaware chancery court. The suit argues that the target managers have breached their fiduciary duties– that the managers' resistance is beyond the pale– and that the managers should be forced to remove their defenses

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2002, as shown on the Thomson Financial *SDC Platinum* database (S. Rossi and P.F. Volpin, 74 J. FIN. ECON. 277, 281 (2004)). They define this as the proportion of listed firms which were targeted in a completed deal during the sample period. In the UK, the figure is 53.65%, and in the US, 65.63%. However, the market capitalisation of listed firms in the UK account for a larger proportion of GDP than do those in the US (see, e.g., A. Demirgüç-Kunt and R. Levine, 'Stock Market Development and Financial Intermediaries: Stylised Facts' World Bank Policy Research Working Paper 1462 (May 1995), 33 (over 1986-1993, ratio of mkt cap to GDP in the UK was 0.92, comapred with 0.64 in the US). When the takeover rates are scaled for the respective size of the stock markets compared to the size of the national economy, this reveals that the UK had a larger proportion of its GDP subject to takeover activity than did the US (49.36% UK vs 42.00% US).

[22] Schneper and Guillén report that during the period 1988-1998, the *SDC Platinum* database of M&A transactions shows 219 hostile bids in the UK, of which 99 were successful, compared with 429 in the US, of which only 97 were successful (W.D. Schneper and M.F. Guillén, 'Stakeholder Rights and Corporate Governance: A Cross-National Study of Hostile Takeovers', Wharton School working paper (2004), 55).

[23] R. Kraakman *et al*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: OUP, 2004), 164.

so that the takeover can be considered by the target's shareholders.[24]

The key players in the drama are lawyers and courts. Each of the relevant parties is advised by lawyers, and contested takeover battles nearly always make their way to the courts. In Delaware, the nation's most sophisticated and efficient corporate law arbiter, this may mean a week or two, and sometimes substantially longer, in the chancery court. The recent battle by Oracle to take over PeopleSoft, to give just one example, required a trial that unfolded over a period of several weeks, while the parties bargained– as vice chancellor Leo Strine has put it, with a bit of exaggeration about his own appearance– "in the glare of the vice chancellor's bald head." The PeopleSoft battled ended when PeopleSoft's managers agreed to the takeover, which obviated the need for either a written opinion or an appeal to the Delaware Supreme Court. But many of the most hotly contested takeover issues are finally resolved after another round of lawyers' arguments in the Supreme Court.

Turn to the UK and the lawyers miraculously disappear. [25] When a hostile bidder launches a takeover effort and believes that the target's managers are interfering with the bid, the bidder lodges a protest with the Takeover Panel. Originally housed in the Bank of England, the Takeover Panel is now located in the London Stock Exchange building. The Takeover Panel--which includes representatives from the Stock Exchange, the Bank of England, the major merchant banks, and institutional investors—administers a set of 'soft law' rules known as the City Code on Takeovers and Mergers.[26] Faced with a protest by one of the parties, the Panel assesses the complaint and issues guidance. It might require that the target board remove its interference with a bid, or instruct the bidder to provide addition disclosure, or in some cases,

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[24] Once the bidder files suit, other target shareholders often file "piggyback" litigation. The Delaware courts usually address the various suits together.

[25] See generally Lord Alexander of Weedon, *Takeovers: The Regulatory Scene*, [1990] J. Bus. L. 203 (1990); T. Peter Lee, 'Takeover Regulation in the United Kingdom' in KLAUS HOPT & EDDY WYMEERSCH, EUROPEAN TAKEOVERS: LAW AND PRACTICE (LONDON: BUTTERWORTHS, 1992), 133; WEINBERG & BLANK, ????

[26] THE TAKEOVER PANEL, CITY CODE ON TAKEOVERS AND MERGERS AND THE RULES GOVERNING SUBSTANTIAL ACQUISITIONS OF SHARES, 7th ed. (BOWNE INTERNATIONAL: LONDON, 2002) plus updates. A regularly updated version of the City Code can be viewed at www.thetakeoverpanel.org.uk.

decline to take any action at all.

Takeover Panel oversight differs from the US framework for regulating takeovers in at least three important respects. First, the Takeover Panel addresses takeover issues in real time, imposing little or no delay on the takeover effort. It is important not to overstate this point. The Delaware courts provide an extraordinarily prompt response to takeover challenges, often deciding the case as soon as the parties have completed their oral arguments. But the combination of SEC oversight of the tender offer and a judicial process for addressing challenges to the target's response builds adds up to at least limited delay. The informality of the Takeover Panel, by contrast, enables it to respond almost immediately. "The reputation of the Panel in the City depends considerably," in the words of one historian, "on the efficiency of the Panel executive in dealing promptly, fairly and decisively with the large number of queries that pour into the office every day. ... If the point is a difficult one, the Panel executive may ask for time to consider, but this is thought of in terms of hours rather than days."[27]

Second, because the Panel relies on soft law, rather than hard law, it also can continuously update its oversight of takeover activity. The Takeover Panel is actively engaged with the parties, which enables it to adjust its response both to the particular parties before it, and to the changing dynamics of business within the City of London.

Finally, as already noted, lawyers play relatively little role in Takeover Panel oversight. The Panel's members come from the principal shareholder and financial groups, and the staff consists primarily of business and financial experts, rather than lawyers, due to a conscious decision from the beginning "that the Panel executive should for the most part be staffed by temporary secondments from City firms."[28] The Takeover Panel is thus business-oriented, rather than legal. The culture could hardly be more different than the lawyers-with-briefcases approach that characterizes American takeover regulation.

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[27] JOHNSTON, p.125.

[28] *Id.* at 127.

III. THE HISTORICAL DIVERGENCE: A BRIEF CHRONOLOGICAL TOUR

The deep divergences in US and UK takeover regulation are surprising on many different levels. After all, when it comes to business and finance, the US and the UK arguably have more in common than any other pair of developed economies. Corporate governance is market-oriented in each country, and the largest corporations are characterized by a separation of ownership and control that is uncommon elsewhere in the world. The legal system in each country has a common law orientation, unlike the civil law approach that characterizes many other countries. Yet, despite all of these similarities, the US and UK use very different strategies for regulating takeovers, the most prominent issue in all of corporate law.

Why did the two nations take such divergent courses? To begin to answer this question, we must delve into the political and historical origins of the two approaches. Once again, we start with the US.

A. What Happened in the US?

Although the US approach to takeovers is often associated with a cluster of Delaware takeover cases of the 1980s, the foundations were laid much earlier. For present purposes, the key events were the advent of the federal securities laws in 1933 and 1934; and more recently, the enactment of two major legislative initiatives in the 1960s: Delaware's 1967 corporate law reforms and the Williams Act amendments to the securities laws passed by Congress the following year.

The 1933 and 1934 securities acts were passed in the wake of the 1929 Crash and the early years of the Depression, and sought to correct the perceived market abuses of the 1920s by imposing new disclosure and antifraud regulation.[29] The 1934 act also established the Securities and Exchange Commission to serve as the principal policeman of the markets. During this same

[29] Like nearly all of America's most important federal corporate regulation, the securities acts were passed in the aftermath of major corporate scandals. For a historical analysis of the enactment of the securities laws, together with the New Deal restructuring of the banking and utilities industries briefly described below, see, e.g., DAVID SKEEL, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM 75-106 (2005).

period at the outset of Franklin D. Roosevelt's presidency, Congress also enacted major banking regulation that separated commercial and investment banking, and established deposit insurance to protect Americans' savings.[30]

With a strong populist wind at its back, the New Deal Congress quite explicitly sought to restructure American business and finance through these reforms. The banking reforms were designed to break the near monopoly that J.P. Morgan and a small group of other banks had on American corporate finance, and to sharply diminish the banks' role in the governance of America's largest corporations. The creation of the SEC then put a governmental regulator in the oversight role that had previously been occupied by the banks and other Wall Street insiders.

Takeovers didn't enter the picture in any significant way for another twenty years. The first hint of a change came in 1954, when Robert Young launched a hotly contested and ultimately successful proxy contest for control of the New York Central Railroad. The Young proxy contest was viewed as an assault on existing norms of Wall Street behavior, which discouraged public challenges to corporate ownership.[31] In the late 1950s and early 1960s, corporate raiders devised the tender offer as an alternative strategy for waging a battle for control. Tender offers were far more effective than the traditional proxy contest because the bidders put their money where their mouth was, as it were. A tender offer was a promise of cold hard cash, rather than simply a plea by the bidder for target shareholders to vote for the bidder's slate of insurgent directors and to trust that the bidder would run the company more effectively.

Hostile tender offers became increasingly common in the 1960s, rising from seventy-nine from 1956-1960, to nearly twice that number from 1964-66.[32] Although a prescient 1965 article by Henry Manne stoutly defended the governance benefits of takeovers, in most quarters they

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[30] The Glass-Steagall Act of 1933, which separated commercial and investment banking, lasted until 1999, when it was largely repealed. Glass-Steagall Act of 1933, ch. 89, 48 Stat. 162 (codified at 12 U.S.C. § 377), *repealed* by Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341.

[31] The Young contest and its implications for American corporate governance and finance, are discussed in RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 508-511 (1990).

[32] *See* Note, *Cash Tender Offers*, 83 HARV. L. REV. 377, 377 n.1 (1969).

were deeply controversial.[33] The premier Wall Street investment banks and law firms refused to represent bidders in a hostile takeover. This left the practice to scrappy upstarts like Joseph Flom, who became the leading takeover lawyer by taking cases the white shoe firms wouldn't touch.

As takeovers and other merger and acquisition activity intensified, lawmakers passed two landmark reforms in the late 1960s. The first was the 1967 amendments to Delaware's General Corporation Law. Based on the recommendations of a "revision committee" commissioned in 1967, Delaware passed its most sweeping corporate law reforms since the end of the nineteenth century.[34] Among the key changes made by the 1967 amendments were a sharp expansion of the powers of a corporation to indemnify its directors, an attempted codification of the standard for reviewing self interested transactions, a provision authorizing cashout mergers, and a reduction of the availability of appraisal rights.[35] Although none of the major changes were directly aimed at the surge in hostile takeover bids, the reforms were designed to address concerns that had frequently been raised by managers. Expanded indemnification provided more protection against the possibility of fiduciary duty litigation, and retrenchment on appraisal rights smoothed the skids for large corporations that had embarked on acquisition campaigns.

More important than the details was the overall effect of the reforms. By the early 1960s, Delaware's pre-eminence as the leading state of incorporation had started to fade. The 1967 reforms spurred a dramatic increase in incorporations and reincorporations.[36] By the 1980s, when the biggest judicial challenges to hostile takeovers began, nearly all of the most important cases would make their way through the Delaware courts.

[33] Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

[34] The template for Delaware corporate law was its 1899 Act, which had been patterned on New Jersey's corporate law statute.

[35] The changes are described in detail in S. Samuel Arsht & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. L. 75 (1967).

[36] *See, e.g.,* William W. Bratton & Joseph A. McCahery, *The Content of Corporate Federalism*, 21-22 (unpublished manuscript, 2004)(noting that Delaware's revenues from chartering had dropped to 7% of its total revenues by 1963, but that its share of the market for incorporations has steadily increased since the 1967 amendments).

The ground rules that defined how the 1980s takeover bids were structured were put in place by the other major 1960s reform, the Williams Act. In 1965, Senator Harrison Williams of New Jersey introduced legislation that he viewed as essential to stop "corporate raiders" and "white collar pirates" from assaulting "proud old companies" and stripping them down to "corporate shells" by "trad[ing] away the best assets" and keeping "the loot" for themselves.[37] To remedy the threat to corporate America, Harrison proposed that bidders be required to announce their acquisition plans at least twenty days before launching a tender offer. He candidly acknowledged that his objective was to assure that corporate managers had ample time to mobilize their opposition to a takeover threat.

One might have expected the principal opposition to Harrison's proposal to come from institutional shareholders such as pension funds and insurance companies whose stock holdings benefited from the premium prices paid by takeover bidders. Clamping down on tender offers would mean fewer takeover premia. But one searches the legislative history in vain for evidence that institutional shareholders entered the legislative fray. Their relative silence may have reflected the fact that the institutions were not particularly well-coordinated, and their overall stock holdings were much smaller than they became in the succeeding decades.[38] Shareholder voice may also have been chilled by the knowledge that American lawmakers get nervous when financial institutions flex their muscles on corporate governance issues.[39]

It was the SEC, rather than shareholders themselves, that raised doubts about Senator Harrison's strategy for cooling off cash tender offers. The Commission worried that the pre-solicitation disclosure obligation would be impossible to implement, and proposed a series of more moderate reforms. During the mid 1960s, the SEC had substantial influence in Washington, due in part to an aggressive Chairman– Bill Cary– and in part because the Kennedy and Johnston administrations were committed proponents of SEC oversight after a long period in

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[37] 111 CONG. REC. 28,57-60 (remarks of Senator Williams), *quoted in* Note, *supra* note [xx], at 381 n.28.

[38] The relative quiescence of institutional shareholders in the US during this era, in sharp contrast to institutions' central role in the UK, is explored in more detail in Part IV, *infra*.

[39] *See, e.g.,* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994).

the 1950s when the SEC seemed to be in hibernation.[40] As a result of the SEC's plea for a less lopsidedly antitakeover bill, Senator Harrison adjusted his proposed the proposed legislation to shorten the pre-solicitation disclosure period to five days, and to give the SEC authority to regulate target managers' missives against a takeover bid, rather than just the bidder's solicitations.[41]

As enacted in 1968, the Williams Act requires disclosure by any party that makes a tender offer that would give it more than five percent of the target's stock; gives shareholders the right to withdraw stock they had initially tendered to the bidder for the first seven days of the offer; requires a bidder to purchase stock on a pro rata basis, rather than purchasing first from the shareholders who tender first; requires the bidder who raises its bid price to pay the higher price even to shareholders who tendered at the lower price; requires that the offer be kept open at least forty days; and prohibits fraud by either side in a tender offer campaign.[42] The overall objective of the new rules was to prevent bidders from conducting so-called Saturday Night Special tender offers– offers that put pressure on shareholders to tender by requiring a rapid decision and making the offer available on a first come, first served basis. Under the new rules, shareholders would have more time to decide and would not be penalized for being the last to tender.

The mantra of the legislative debates was "neutrality." According to its proponents, the Williams Act would level the playing field between bidders and target managers by preventing bidders from using the blitzkrieg tactics that they had sometimes employed. In reality, of course, leveling the playing field meant helping target managers out in the name of shareholder choice. Managers clearly benefited from the new rules, since they now had enough time to wage an effective campaign against a hostile bidder. The bidders clearly lost. Whether shareholders won or lost is a closer question, since they benefited from the elimination of coercive bids but lost to the extent the new rules had a chilling effect on cash tender offers.

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[40] Kennedy's enthusiasm for the SEC began close to home: his father Joseph had been the SEC's first chair in 1934.

[41] *See, eg.,* Note, *supra* note [xx], at 381 n.28.

[42] For an overview of the Williams Act changes, see, e.g., Note, *The Developing Meaning of 'Tender Offer' Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1254-60 (1973).

The final pieces in the puzzle of US takeover regulation came in the wake of the takeover boom of the 1980s. Fueled by a combination of Michael Milken's discovery of the financing potential of high yield debt, deregulation, and a kinder, gentler approach by the Reagan administration to antitrust regulation, takeover activity soared to a level not seen since the great merger wave at the end of the Gilded Age. Target managers fought back with a variety of defensive strategies, the most dramatic of which was implementation of the poison pills pioneered by Marty Lipton of Wachtel, Lipton. Since the poison pill seemed to be capable of stopping a bidder in its tracks, bidders challenged pills and other defenses as an impermissible interference with their efforts to make a tender offer to target shareholders.

The battleground on which the challenges were addressed was the Delaware courts, where roughly half of America's largest corporations were incorporated. In 1985, the Delaware Supreme Court issued three landmark opinions that completed the landscape of American tender offer regulation. In *Moran v. Household Int'l, Inc.*, Delaware held that poison pills are not per se impermissible, despite the fact that they discriminate between the tender offer bidder and other shareholders of the target company.[43] In *Unocal* and *Revlon*, the court then sketched out the initial limitations of target managers' use of poison pills and other defenses.[44] In order to defend against a takeover, managers would be required to show that the hostile offer represented a threat to the corporation and that the defense was reasonably proportionate to the threat. If it became clear that the company would be sold or broken up, managers' use of defenses would be limited still further: defenses would be permissible only to the extent target managers used them to try to get the highest price for their shareholders.

Although the Delaware caselaw gave managers far more discretion than they would enjoy in a shareholder choice regime for regulating targets, target managers persuaded the legislatures of other states to give them even more protection. By the end of the 1980s, over forty states had enacted antitakeover legislation that protected the managers of companies incorporated in the state. In many states, the legislation was enacted at the behest of a particular company. In a few

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[43] 500 A.2d 1346 (Del. 1985).

[44] Unocal Corp. V. Mesa Petroleum Co., 493 A.2d 946 (1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).

others, the debate was somewhat more prolonged. But nearly everywhere, state legislatures gave target managers new tools for resisting unwanted takeover bids.[45]

B. What Happened in the UK?

As in the United States, the early history of hostile takeovers in the UK dates to the early 1950s. Three related factors appeared to have contributed to their appearance at this time. First, governments in the immediate postwar era imposed onerous income taxation on dividends paid to individuals, whilst asking companies to exercise restraint in paying dividends, leading companies to hoard cash.[46] Secondly, the Companies Act 1948 introduced new disclosure obligations making corporate accounts—and the existence of such cash reserves—much more transparent than ever before.[47] Thirdly, surging postwar inflation pushed the real value of companies' fixed assets—particularly land—completely out of line with their balance sheet representations at historical cost.[48] Yet the heuristics used by investors to price stocks in the market were not immediately updated to reflect these changes. They were instead based largely on dividend yields, and so fell on the basis of dividend restraint.[49] This created an unprecedented opportunity for quick profit-making, which enterprising businessmen were not slow in taking. As a result, the 1950s saw a wave of takeover efforts that would soon lead to complaints both from bidders and from target shareholders, and to calls for governmental intervention.

Two of the earliest takeover battles give a flavor of the issues at stake. In early 1953,

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[45] [CITE Roberta Romano, Henry Butler].

[46] ECONOMIST, December 19, 1953, at 904; EDWARD STAMP & CHRISTOPHER MARLEY, ACCOUNTING PRINCIPLES AND THE CITY CODE: THE CASE FOR REFORM, 9 (1970).

[47] Les Hannah, *Takeover Bids in Britain Before 1950: An Exercise in Business 'Pre-History'*, 16 BUS. HIST. 65, 75-76 (1974).

[48] ECONOMIST, December 19, 1953, at 904; July 4, 1959, at 41.

[49] This, it appears, was because historically very little financial information had been made publicly available about listed companies, and investors relied upon the regular payment of dividends as a credible signal of managers' commitment to investors. See Brian R. Cheffins, Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom (Working Paper, University of Cambridge Faculty of Law, 2005).

Charles Clore made a bid for J. Sears and Co. The directors of Sears fought back by promising to boost the Sears dividend, proposing a bonus issue of shares, and revaluing the firm's property to reflect its higher current value. But the directors' last ditch stand was to no avail. A large majority of the Sears shareholders accepted Clore's offer. Clore then sold and leased back much of Sears' property to take advantage of inflated property values, and he used the cash from these transactions to finance subsequent takeover bids.[50]

Later the same year, the directors of Savoy Hotel Ltd caught wind that Harold Samuel's Land Securities Investment Company (LSIC) intended to make a bid for Savoy. LSIC was most interested in the Savoy's Berkeley hotel, which it planned to convert into commercial offices. To scuttle this plan, the Savoy directors created a new company called the Worcester (London) Co, and allotted voting shares in Worcester to the trustees of the Savoy Hotel staff benevolent fund (one of whom was the chairman of the Savoy board). The directors then transferred the Berkeley hotel to Worcester, then leased it back to Savoy pursuant to a lease that required that the building be used only as a hotel.[51] In the language of contemporary corporate law scholarship, the Savoy directors' scheme amounted to a clever but blatant embedded defense. Once the dust settled, there was no immediate way that an outside bidder could turn the hotel into an office building.[52] Even if the bidder ousted Savoy's current directors, the company that held title to the Worcester hotel would still be controlled by the trustees of the employees' pension. Nor were Savoy's shareholders given any say in the matter.[53]

The disgruntled Samuel called for a Board of Trade inquiry into the Savoy stratagem.[54]

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[50] SIR ALEXANDER JOHNSTON, THE CITY TAKE-OVER CODE, 11 (1980).

[51] ECONOMIST, December 12, 1953, at 831-32.

[52] *Ibid.*; RONALD W. MOON, BUSINESS MERGERS AND TAKE-OVER BIDS: A STUDYOF THE POST-WAR PATTERN OF AMALGAMATIONS AND RECONSTRUCTIONS OF COMPANIES, 5th ed., 128-32 (1976).

[53] The recent emergence of hostile takeover activity in Japan gave rise to a similar sage. After Livedoor, a relatively small internet company, acquired a 35% stake in Nippon Broadcasting in an effort to obtain access to Nippon's 25% equity interest in Fuji RV, Nippon stymied the incipient takeover by loaning its Fuji stock to Daiwa Securities and Softbank investment. *See, e.g.*, Michiyo Nakamoto, *Historic Battle Establishes Combat Rules*, FIN. TIMES, June 27, 2005.

[54] ECONOMIST, December 12, 1953, at 832.

The Board's report concluded that although the Savoy directors had done what they thought was best for the company, the scheme had effectively rendered "irrevocable for all time the policy view of the present board," [55] and was strongly critical of the way in which the scheme deprived the Savoy's shareholders of control. Yet although the report, which was prepared by an eminent company law barrister, condemned what had happened, it lacked the binding force of a court judgment. Direct judicial precedents were non-existent. Indeed such was the undertainty that another leading counsel had advised the Savoy directors that their scheme was consistent with existing precedents.[56]

Several years later, at the end of 1958 came perhaps the most notorious takeover struggle of all: the battle for British Aluminium. The managers of this company outraged its shareholders by rejecting an approach from the US Reynolds Metal Company, in partnership with UK-based Tube Investments, and accepting an inferior deal with the Aluminium Company of America ('Alcoa'), without bothering to inform shareholders of either development.[57] When TI-Reynolds went over the BA board's heads with an offer directly to the shareholders, it emerged that the board's plan was to sell fresh shares direct to Alcoa, which under the company's constitution did not require the approval of its shareholders. The BA board then attempted to bribe shareholders with a generous increase in dividends, which increased the share price but only served to provoke further anger that the terms of the Alcoa issue had been set at the previous—much lower—price.[58] Many of the shareholders responded by selling to TI-Reynolds, thumbing their noses at the BA board.

What transformed this affair into the 'cause célèbre of the decade',[59] was the open

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[55] E. MILNER HOLLAND QC, REPORT OF THE BOARD OF TRADE INVESTIGATION INTO THE SAVOY HOTEL CO LTD, June 14th, 1954, at XX.

[56] MOON, *supra* n 52, 130.

[57] ECONOMIST, December 6, 1958, 913-15. The board's motivation, it appears, lay in the fact that the Alcoa deal promised to permit them to remain in office for the foreseeable future. *Id.* at 914; ECONOMIST, December 13, 1958, 1006..

[58] ECONOMIST, December 27, 1958, 1173.

[59] STAMP & MARLEY, *supra* n 46, 8.

sparring that broke out between various camps within the normally closed ranks of the City's financial community. TI-Reynolds were advised by S.G. Warburg, a recently-founded merchant bank that was one of the few advisers willing to dirty its hands with the messy business of takeover bids and viewed by many in the City's cosy community as an upstart outsider.[60] Early in 1959, a syndicate of fourteen 'old school' merchant banks, consisting of the financial advisers to managers of blue-chip companies, entered the fray publicly on behalf of BA's beleaguered management by offering to buy half of any holdings in the company on the condition that investors retain the other half until the TI-Reynolds bid had lapsed.[61] The syndicate urged shareholders—and in particular, institutional investors—to support their cause on grounds of 'national interest', alleging that the Alcoa deal was the only way that BA could remain in British hands.[62] The institutions, however, smelt a rat, for both Alcoa and Reynolds were US firms. Rather, it appeared to all concerned that the old-school merchant banks were flexing their muscles in an unseemly fashion in order to protect the perceived interests of their clients—the managers.[63] Moreover, the managers had acted in blatant disregard of the shareholders' interests. The institutions' response was quick and devastating: they dumped BA stock as fast as TI-Reynolds could buy it, thereby sealing the incumbent management's fate.[64]

To the American mind, at least, the most logical response to the growing tensions might have been for bidders or institutional shareholders to take their grievances to the courts, challenging the tricks target managers were using to tilt the playing field. This, of course, is how the parties responded– and still respond—in the U.S. And there were indeed hints that bidders in particular might use the judicial system to challenge target managers' defensive tactics. But the British response took a very different form, a form that eschewed both litigation and the imposition of mandatory statutory rules for policing takeovers. Company law at the time was perceived as unduly permissive and uncertain. Resolution of the issues through litigation would

[60] STAMP & MARLEY, *supra* n 46, 6-7.

[61] ECONOMIST, January 3, 1959, 62.

[62] *Ibid.*

[63] ECONOMIST, January 10, 1959, 147; STAMP & MARLEY, *supra* n 46, 7-8.

[64] ECONOMIST, January 10, 1959, 145-47.

have taken years and simply deepened the cracks that the British Aluminium affair had caused to show in the fabric of the City's business relations.

In the wake of the British Aluminium debacle, the Governor the Bank of England invited a Committee comprised of the trade groups that represented the merchant banks, the institutional investors, the largest commercial banks and the London Stock Exchange to devise a code of conduct to regulate takeover bids.[65] (Interestingly, neither of the major management-side organizations, the Institute of Directors or the Association of British Chambers of Commerce, was involved in the principal deliberations, though both set up committees to coordinate their response to the issue of take-over bids.[66]) It seems likely that this initiative was prompted, at least in part, by the fear that if action were not seen to have been taken, then the matter would be taken out of the City's hands by legislation.[67]

By the end of 1959, the Bank's Committee had produced a document entitled "Notes on Amalgamations of British Businesses." The Notes offered a series of general guidelines that were "concerned primarily to safeguard the interests of shareholders."[68] The first of the Notes' four main principles stated that there should be no interference with the free market in shares, and the second that it was to be for the shareholder himself to decide whether to sell. The Notes also called for shareholders to be given enough information to make an intelligent decision, and enough time to digest it.[69] In keeping with the gentlemanly spirit in which the City did business at the time, the principles established by the Notes were dubbed the "Queensbury Rules", after the rules drafted by the Marquess of Queensbury which were the first to regulate prize-fighting.[70]

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[65] ECONOMIST, October 17, 1959, 270. Those involved were the Issuing Houses Association, the Accepting Houses Committee, the Association of Investment Trusts, the British Insurance Association, the Committee of London Clearing Bankers and the London Stock Exchange (ECONOMIST, October 31, 1959, 440).

[66] ECONOMIST, October 24, 1959, 358.

[67] The Board of Trade announced the setting up of the Jenkins Committee on company law in November 1959.

[68] THE TIMES, Oct. 31, 1959.

[69] ECONOMIST, October 31, 1959, 440-42.

[70] Maurice Wright, City Rules OK? Policy Community, Policy Network and Takeover Bids, Manchester Papers in Politics, September 1987, at 30.

As *The Economist* put it,

> 'These are rules of conduct which have been followed by sensible and responsible people in industry and in the City for most of the time. They do not deny businessumen the right to fight out an issue, but they do establish Queensbury rules against low hitting and butting with the head.'[71]

The Notes thus established the principle of shareholder primacy as respresenting best practice in the City community. [Discuss 1960 Rules and Jenkins Report].

Although the Notes were generally well-received, their influence on the UK takeover market was shaky in the years that followed. In early 1963, the battle for Whitehead Iron and Steel provided the immediate impetus for a revision of the *Notes*.[72] Here the successful bidder, Richard Thomas and Baldwin, bought heavily from institutions to whom it guaranteed to pay the difference between the market price paid and any final offer price.[73] Controversially, the same terms were not extended to smaller investors.[74] Dissatisafaction with this and other instances lead the Committee to reconvene, the resulting *Revised Notes* responded to some of the complaints by expanding information obligations and a requiring that all shareholders receive the benefit of any increase in bid price.[75]

Nevertheless, the mid 1960s saw a series of takeover bids that seemed to continue to flout the spirit of the Notes. The bidders for Outram (a publisher), Pye (a radio manufacturer) and Cook & Watts (a textile wholesaler) each buttressed its bid by buying stock on the open market for more than it offered in its eventual bid, thus undercutting the Notes' exhortation to equal treatment.[76] By mid 1967, *The Economist* was ready to say final rites over the Notes. The

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[71] ECONOMIST, October 31, 1959, 442.

[72] Also salient at the time would have been a bid for Courtaulds by ICI in 1962, in which …

[73] __ Penrose, *Some Aspects of the Development, Criticism and Control of Takeover Bids Since 1945*, XX JUR. REV. 128, 132 (1964).

[74] This led at least two major institutions to shun RTB's offer in outrage: ECONOMIST, February 9, 1963, 538.

[75] ECONOMIST, November 2, 1963, 511. The *Revised Notes* were published on 31 October 1963.

[76] [cite]

widespread evasion of the Notes' principles, its writers concluded, made the notes a dead letter.

The financial press suggested that the only hope for a well-functioning takeover market would be to set up a governmental agency with oversight authority. *The Times* called for "joint action by interested parties– jobbers, brokers, the Issuing Houses Committee and the institutions– to set up a watchdog organization on the lines of [the Securities and Exchange Commission in the US]."[77] *The Economist* would also chime in in favor of a British SEC in the months that followed.[78] But the British SEC was not to be. Prime Minister Harold Wilson acknowledged that the City was going through a period of crisis, but insisted that statutory rules, and direct governmental action, were not the answer. Within a few days, the Working Party had reconvened to begin work on a new set of takeover principles. In September, the process took a major step forward when the Governor of the Bank of England proposed that a Panel consisting of the chairmen of the organizations represented in the Working Group be established to oversee the drafting and administration of the new takeover code.

By the beginning of 1968– the year when US lawmakers enacted the Williams Act's federal tender offer rules-- the Drafting Committee had completed a draft of the code for consideration by each of the trade groups. The new Code was much more specific than the original Notes. Not surprisingly, many of its details could be traced to the problems that had surfaced in the takeover battles of the early and mid 1960s. Under the new Code, the managers of a target corporation would not be permitted to take any action to frustrate a bid without the approval of the target shareholders; bidders were instructed to treat all of the shareholders of any given class of target shareholders similarly; and both parties were told that any information given to some shareholders should be given to all shareholders.

The new Panel didn't lack for business in its first year of operations. Between March 1968 and the same month a year later, the Panel would handle 575 takeover cases. Unfortunately, the Panel's treatment of its most important early test, a battle between Courtaulds and Dufay Bitumastic for International Paints, did not bode well for the efficacy of the UK's self regulatory approach. Shortly before the Dufay offer was scheduled to close, Courtaulds

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[77] THE TIMES, July 18, 1967.

[78] *See, e.g.,* ECON., July 20, 1968, at 76.

announced its plan to make a bid, but it conditioned the bid on failure of the Dufay offer and was silent about the value of the bid it planned to make. The mystery surrounding Courtaulds' offer forced the International Paints shareholders to make their decision on Dufay's bid with almost no information about terms of the competing offer. In the end, the shareholders held their breath as the Dufay bid failed and Courtaulds then won the contest. The only sanction the Panel levied on Courtaulds for its failure to provide meaningful information was a "public rap over the knuckles."[79] Courtaulds' disdainful response– a very public thumbing by Sir Frank Keaton, Chairman of Courtaulds, of his nose at the attempted oversight-- pointedly underscored the Panel's limitations. "[T]he cult of the gifted amateur is the new Takeover Panel's main defect," Keaton opined. "It has no teeth, no legal sanctions– in fact, to me it's all a kind of confidence trick."[80] Like the financial press, Keaton believed that the only effective strategy for regulating the takeover market would be to create a British SEC that had formal legal sanctions at its disposal.

Over the next several months, the Panel's limited success in policing two more high profile takeover battles– a contest between American Tobacco and Philip Morris for Gallaher, a British tobacco company; and a battle for News of the World that pitted Robert Maxwell against Rupert Murdoch– prompted still louder cries for change. The *Economist* complained that aggressive bidders are running "coach and horses through the Code" and insisted that the time had come for a "professional referee" with a full range of legal sanctions at its disposal.[81]

Despite the outcry, Prime Minister Wilson once again demurred on the proposals for a British SEC. "[T]he Government has no desire," he announced at the Lord Mayor's banquet in London in November 1968, "to introduce legislation to force on the City the much more wide-ranging interference with free enterprise America has devised in the form of the Securities and Exchange Commission, or indeed in any other form, for this job is far better done by the City."[82] While rejecting the SEC approach, Wilson also acknowledged that the Panel's efforts fell far

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[79] STAMP, p.29.

[80] *Id.* at 25.

[81] ECONOMIST, July 20, 1968, at 76.

[82] Quoted in JOHNSON, *supra* note [xx], at 49-50.

short of adequate oversight. Wilson called for the Panel to take matters into its own hands, but made clear that the Government would be forced to step in unless the Panel quickly reformed its oversight techniques.

Even before Wilson's speech, the City Working Party had begun meeting to revise the City Code and Takeover Panel. Over the next several months, they made three major changes that would transform the operations of the Panel. The first change was to reorganize various aspects of the Panel. Lord Shawcross was brought in to serve as chairman,[83] and the Panel's operations were moved from the Bank of England to the London Stock Exchange. The Working Party also added a procedural protection to the Panel's decision making authority: under the new Code, any party would be entitled to appeal from a Panel decision. Second, technical and in a few cases substantive changes were made to many of the provisions of the Code. The most significant new rule prohibited bidders from dealing in the shares of the target corporation during the offer period. Finally, and most important by far, the sanctions available to Panel were beefed up considerably. Rather than calling for statutory sanctions– an idea that was considered and rejected– the Working Party chose to piggyback on the existing authority of the Stock Exchange and the Board of Trade. The Stock Exchange had the power to censure, suspend or expel a company from the Official list, and the Board of Trade had similar authority over dealers. Under the new Code, all of the bodies represented in the Working Party agreed to accept the Panel's jurisdiction and to impose the specified sanctions on their members if asked by the Panel to do so.

The status of the Panel and Code as respected regulators of UK takeovers was sealed by a 1969 takeover of Pergamon Press by American Leasco Data Processing Equipment Corp. A series of murky developments at Pergamon Press, 31% of which was held by Robert Maxwell, gave Leasco cold feet about the deal. Leasco's decision to withdraw triggered Rule 12 of the Code, which required that an offerer who announces an intent to make an offer must proceed to a formal offer or justify its decision to forgo the offer to the Panel. The Panel accepted Leasco's claims that it was misinformed about the extent of Maxwell's involvement and the state of Pergamon's subsidiaries, then proceeded to negotiate a new merger agreement between the

[83] [describe Shawcross's background?]

parties. The Panel insisted on full disclosure, and asked the Board of Trade to conduct an investigation into Pergamon's affairs. Although a few observers (including the *Economist*) continued to voice doubts, the Panel's decisive intervention greatly enhanced its credibility and quieted calls for a British SEC.

The emergence of the Panel as the principal source of regulatory oversight over UK takeovers can hardly be described as an illustration of spontaneous order in action. The norms-based, self regulatory order emerged only after sustained governmental arms twisting. But the regulatory strategy that emerged during the same era as Delaware enacted its 1967 reforms and the SEC helped to shape the 1968 Williams Act looks remarkably different from the US approach. Unlike in the US, where the contours of takeover regulation are hammered out in the courts, the Panel approach managed to keep lawyers out of the process. And despite the steady drumbeat of calls for a "professional regulator," UK lawmakers continued to look to coerced self regulation rather than an American style SEC as the principal source of oversight in the takeover context.

IV. EXPLAINING THE DIVERGENCE: FROM PROCESS TO SUBSTANCE

Having briefly chronicled the remarkable divergence of US and UK takeover regulation, we come now to the heart of our analysis, attempting to explain why the US and UK have taken such different paths when it comes to regulating takeovers. We begin our analysis with the most obvious explanation– an explanation derived from the marvels of American federalism. As we shall see, however, this "orthodox" story cannot fully explain why shareholder-regulation never emerged in the US, or why lawyers and the SEC are absent in the UK. The standard story, as it turns out, raises nearly as many questions as it answers. We therefore turn to a richer analysis that draws on the historical developments described in the previous part, then conclude by considering the relationship between the mode and the substance of regulation.

A) The Orthodox Story: Federalism and Pro-Manager Takeover Law

For even longer than they have been debating directors' proper response to takeovers, American corporate scholars have debated whether Delaware's supremacy as the state of choice for America's largest corporations is the product of a "race to the bottom" or a "race to the top."[84] The race to the bottom view posits that state lawmakers cater to managers, and thus have powerful incentives to favor managers at the expense of shareholders, whereas race to the top advocates believe that market pressures force Delaware and other states to regulate with shareholders in mind. The federalism that makes this state lawmaking possible provides the most obvious explanation for the US approach to takeover regulation.

In the past decade, a more subtle version of the original race to the bottom theory has emerged, and has become increasingly influential in corporate law circles. This view proposes that charter competition isn't really a competition at all. Delaware, which roughly sixty percent of the largest corporations now call home, has a monopoly share of the market.[85] Delaware's monopoly is made possible, in part, by the fact that Delaware doesn't really compete with forty-nine other states in an open, nationwide competition. The reality is that Delaware competes with only one other state at a time– the "home" state of a corporation that is considering relocating to Delaware.[86] The upshot is that Delaware has at least some ability to favor managers' interests, and it can charge supercompetitive prices for the privilege of incorporating in the nation's second smallest state.

It is a short step from this new orthodoxy to a straightforward political explanation for the divergence of US and UK takeover regulation. In the US, federalism has amplified the voice of corporate managers. Because they worry that managers will pack the company's bags and move

[84] The wellspring of the debate in its current incarnation was a scathing indictment of Delaware by former SEC chair William Cary. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). Delaware's leading defender is Roberta Romano. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993). With the advent of the EU, the debate has become a staple in the European literature as well. [**cites**]

[85] *See, e.g.,* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law,* 55 STAN. L. REV. 679 (2002).

[86] *See, e.g.,* Lucian Bebchuk, Alma Cohen, & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law*, 90 CAL. L. REV. 1775 (2002).

elsewhere if the state is insufficiently attentive to the managers' needs, state lawmakers have powerful incentives to keep corporate managers happy.[87] This suggests that managers will often get what they want both in Delaware and in other states. In the UK, by contrast, which does not have this federalist structure, corporate managers exert far less influence.[88]

The orthodox account rings true in some respects. Managers clearly do influence the shape of state corporate law– particularly with respect to takeovers. But the federalism story also has at least two puzzling limitations. First, while the orthodox story is a superficially plausible explanation of the general substantive content of US takeover regulation, it seems to assume that Delaware law is likely to be seriously inefficient. If Delaware judges and lawmakers have a greater stake in pacifying corporate managers than any other state, their handiwork should be more manager-friendly and less shareholder friendly than corporate regulation in other states. Yet this conclusion doesn't fit very well with the existing evidence. Delaware was one of the last states to enact an antitakeover statute, for instance, and its statute is much weaker than the statutes rushed into the code books by other state legislatures.[89] There is also strong empirical evidence that reincorporating in Delaware increases a company's value, rather than undermining

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[87] Reincorporation does require a shareholder vote, but race to the bottom theorists argue that the vote is an ineffective check, either because of shareholders' collective action problems or because the reincorporation vote is muddied by other, more positive reasons for moving to the new state.

It is important to emphasize that reincorporation is not the only step a company can take to reduce its presence in its current home state. The company can also move some or all of its operations elsewhere– a step that often can be achieved without any shareholder input. For an argument that this structural influence explains why the states were slow to adopt a social safety net, see Jacob S. Hacker & Paul Pierson, *Business Power and Social Policy: Employers and the Formation of the American Welfare State*, 30 POL. & SOC. 277 (2002).

[88] Geoff Miller, one of the few commentators who has considered the US-UK contrast in takeover regulation, reaches a similar conclusion in a brief discussion of the political dynamics. "The federal principles which generate strong pressures for antitakeover legislation at the state level in the U.S.," he notes, "are not present in England. ... In such an environment, antitakeover legislation is unlikely to be observed." Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between The United States and England*, 1998 COLUM. BUS. L. REV. 51, 75 (1998). Miller's analysis differs somewhat from ours in that he focuses on the political influence of potential bidders and targets, but doesn't consider the role of shareholder and merchant banking interests in shaping the UK takeover law.

[89] *See, e.g.,* Roberta Romano [FORD. L. REV. article].

it.[90] Delaware's critics have labored mightily to explain these observations, but the evidence suggests that a theory that is predicated on an assumption that Delaware corporate regulation is less efficient than other states may not be the whole story.

The second limitation dramatically deepens the mystery. As our historical analysis has shown, the single most striking difference between US and UK takeover regulation is the mode of regulation: the US looks to formal law, whereas norms-based self regulation holds sway in the UK. Yet the orthodox federalism story does not seem to give us tools for understanding why US and UK takeover regulation differ not just in substantive terms, but also in the principal mode of regulation.[91] To develop a more compelling political account, we need to start by explaining the divergent modes of regulation.

B) Explaining the Modes of Regulation: Why Law vs. Norms?

To identify the starting points for a richer political account, we need only return to our historical overview and ask, which of the players and events that figured prominently in the historical development of US and UK takeover regulation seem to be missing from the orthodox federalism story? The answer, in our view– the dogs that didn't bark in the last section-- are institutional shareholders and the SEC, together with the securities acts from which the SEC sprung, fully formed. Together, they hold the key to understanding the divergent modes of regulation in the US and UK.

First, institutional shareholders played a much more visible role in the development of UK takeover law than in the US. To understand why UK institutional shareholders bulk larger, the best place to turn is to Mark Roe's political account of the contours of American corporate governance.[92] Roe attributes the relative quiescence of America's institutional shareholders to

[90] Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001).

[91] Thus, Lucian Bebchuk has pointed to the UK approach in support of an argument for new mandatory shareholder choice regulation in influential recent work without addressing the fact that UK takeover regulation relies on self regulation rather than formal, mandatory law. *See, e.g.,* [118 Harv. L. Rev at 847-50].

[92] MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

popular mistrust of concentrated financial power in the US.[93] Each time large financial institutions were poised to play an outsized role in American corporate governance in the twentieth century, Roe argues, politicians intervened, forcing corporate ownership to remain fragmented and discouraging big financial institutions from substantially raising their profile. Although mutual funds, pension funds and other institutional shareholders now hold a large percentage of US equities, they still lag behind their UK counterparts, and the differences were even larger during the period when takeover regulation was developing. In 1963, during the early years of the Code, institutional shareholders held over 30 percent of the British market, a percentage that climbed to 57.9 percent in 1981 and over 60% in 1992.[94] US institutions had smaller (though sizeable) stakes throughout this period, and a correspondingly smaller role.[95]

The second, closely related factor was the enactment of the US securities laws in 1933 and 1934. The securities acts are best known for ushering in a new system of disclosure and antifraud regulation, and for establishing the SEC to police the American securities markets. More important for present purposes, however, is the effect that the securities acts had on the mode of American securities regulation.

To appreciate how the securities acts altered the mode of US regulation, consider the role that the principal pre-1930s regulator– the New York Stock Exchange– played in the first three decades of the twentieth century. In response to increasing complaints about the opacity of corporate finances, the NYSE gradually began imposing disclosure requirements on the companies it listed. "By 1934," Paul Mahoney notes, "the NYSE had for many years required listed companies to provide stockholders with a balance sheet and income statement in advance of each annual meeting. By 1928, the annual financial statements had to be audited by an independent auditor. Beginning in the early 1920s, the Exchange began to push for companies to agree to quarterly reporting, and such undertakings were already common in listing agreements

[93] Federalism enters Roe's story as part of the explanation why populist mistrust has proven so politically powerful.

[94] Black & Coffee, 92 MICH. L. REV. at 2008.

[95] [**cite** to US percentages: from Roe?]

by the mid-1920s."[96]

Although the New York Stock Exchange was a private entity– a "private club" in William Douglas's dismissive term[97]– most of the nation's largest corporations were listed on the exchange. The NYSE listing rules thus served as a form of industry self-regulation similar in many respects (though different in others, as discussed in the next section) to the current strategy for regulating takeovers in the UK.

The New Deal reformers believed that the NYSE's regulatory efforts were inadequate– that more disclosure was needed and that the NYSE too often looked the other way when companies failed to honor the existing rules. Because of this, and as part of their larger campaign to minimize the influence of Wall Street insiders in American corporate governance, the reformers quite consciously wrested oversight authority away from the exchange and enshrined it in the securities acts and the rules promulgated by the SEC. This meant that the primary source of securities regulation would be mandatory federal oversight by Congress and the SEC, rather than ongoing adjustments of the sort we see in the UK.

The securities acts also had a more subtle, geographical effect. One of the factors that has made self-regulation effective in the UK, as we have seen, is the fact that all of the major players are located in close proximity to one another in the City, London's ancient business district. This makes the temporary "secondments" used to staff the Panel much simpler than if the banks and institutions were scattered throughout the country, and it means that the bankers and institutional shareholders rub shoulders on a daily basis.

Although America's financial institutions have always been more widely flung than their UK counterparts, until the 1930s the largest players were concentrated on Wall Street. So long as the stock exchange and most of the largest shareholders all walked the same streets of lower Manhattan, it was conceivable that informal rules for takeovers might have developed in the 1950s or 1960s– or indeed, that lawmakers might have pressured shareholders and the exchanges

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[96] Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1466 (1997). For a much more critical account of NYSE self regulation, see Robert Prentice [CITE to *The Need for a Strong SEC* article].

[97] WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 65 (1940).

to develop informal rules, as the Bank of England did in the UK.[98] But the securities acts added Washington DC to the regulatory map, thus making it impossible to replicate the geographical proximity we in the UK. In the US, visiting all of the relevant players would require trips to Wall Street, Washington and– because fiduciary duty principles are still regulated by the states– Wilmington and Dover, Delaware.

The New Deal reformers viewed the fragmentation caused by the securities acts and related New Deal reforms as a great victory, and in many respects they were right. But an important effect of the regulatory map they left– an effect with more equivocal implications– was to assure that American takeover regulation would shaped by courts and mandatory federal rules rather than norms-based self regulation.

C. From Mode to Content: The Final Piece of the Puzzle

In our view, the way in which the two systems have allocated the power to *make* the rules regulating the conduct of hostile takeovers has directly influenced the content of these rules. That is, the differences in the *substance* of the regulation are attributable, at least in part, to the differences in the *mode* of regulation. The essence of our claim is based on public choice theory. In the case of the UK, the application is straightforward: private rules are likely to come to favour the interest groups responsible for their production: in the case of the City Code, the institutional shareholders.

In the US, the most significant aspects of takeover regulation are made by Delaware judges. Judge-made law, which represents the accumulation of precedents of earlier decisions, was thought by early law-and-economics scholars to exhibit an inbuilt tendency to evolve towards efficient rules. However, these sanguine early claims have now been replaced by a more pessimistic literature, which recognizes that judge-made law may be subject to rent-seeking in a way that is not structurally dissimilar to statute.[99]

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[98] [Note that an informal "Gentleman's Code" discouraged white shoe investment banks from participating in hostile takeovers in the US in the 1960s. This may suggest the importance of an external government prod, rather than self-regulation alone; it also reinforces the point that it's important to have all of the shareholder groups at the table, not just one– the investment banks].

[99] For an up to date review of the literature, see Paul H. Rubin, *Micro and Macro Legal Efficiency: Supply*

To understand this, we must turn to the scholarship on the evolution of common law rules. A fundamental point is that judges can only decide cases that are argued before them.[100] Thus the decision to litigate acts as a filter for the evolution of the common law. Or, to put it another way, it represents the 'demand side' of common law judicial rule-making.[101] Where all parties have equal access to funding, and equal likelihood of being involved in future litigation, then it is to be expected that, over time, inefficient rules will be litigated more frequently, as they cause parties to incur greater costs.[102] Under these ideal circumstances, the common law will exhibit a tendency to evolve towards efficient rules.

However, this optimistic assessment does not hold for rules governing types of dispute in which one type of litigant has a systematically greater incentive or ability to litigate.[103] For example, if one class of party is a repeat player, then they will have a greater incentive to litigate than a class of party who is not, because they will be able to internalise the future benefits of a

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and Demand, 13 SUP. ECON. REV. 19, 21-27 (2005).

[100] A point first made in Paul H. Rubin, *Why is the Common Law Efficient?* 6 J. LEG. STUD. 51 (1977).

[101] To be sure, in an environment characterized by regulatory competition, judges will have systematic incentives to favor parties who make the choice. Where the choice is made by both parties (e.g. contractual choice of law) then these incentives may be efficient. Where it is systematically made by one party (e.g. tort law) then the incentives will be inefficient: see Todd J. Zywicki, 'The Rise and Fall of Efficiency in the Common Law: A Supply-Side Analysis' 97 Nw. U.L. Rev. 1551 (2003). For the classic supply-side, interest group account of Delaware corporate law, see Jonathan R. Macey & Geoffrey P. Miller, 65 TEX. L. REV. 469 (1987). Bebchuk argues that this supply-side mechanism is primarily responsible for the manager friendliness of US takeover law as compared with its UK counterpart. In contrast, our explanation focuses on the demand side, and shows that in relation to the UK's *common law*, where similar demand-side circumstances prevail, the results are substantially similar to those in the US. See *infra*, text to nn 112-120.

[102] George L. Priest, 'The Common Law Process and the Selection of Efficient Rules', 6 J. Leg. Stud. 65 (1977); John C. Goodman, 'An Economic Theory of the Evolution of the Common Law', 7 J. Leg. Stud. 393 (1979); Avery Katz, 'Judicial Decisionmaking and Litigation Expenditure', 8 Int'l. Rev. L. & Econ. 127 (1988).

[103] Jack Hirschleifer, 'Evolutionary Models in Economics and Law', in Paul H. Rubin and Richard Zerbe (eds.), 4 *Research in Law and Economics* 1 (JAI, 1982); Paul H. Rubin, 'Common Law and Statute Law', 11 J. Leg. Stud. 205 (1982); Martin J. Bailey and Paul H. Rubin, 'A Positive Theory of Legal Change', 14 Int'l Rev. L. & Econ. 467 (1994).

favourable precedent.[104] Similarly, a class of party with systematically greater access to funding for litigation may be expected to be more willing to sue and once again, all other things being equal, the shape of common law rules may be expected to come to favour them. What is worse, groups of lawyers who act for particular classes of litigant may have their own interest in shaping the development of the law in a way that maximises their income.[105]

In the context of litigation regarding directors' duties in responding to hostile takeovers, there are likely to be two types of plaintiff: jilted bidders and dissatisfied target stockholders. Of course, the two will overlap, in that the bidder's standing to sue will come from the shares it has acquired in the target, but we treat them separately because the bidder's financial interest in the takeover transaction is materially different from that of the (other) target stockholders. The jilted bidder will usually be seeking an action for injunctive relief, so as to permit the transaction to go ahead, and will expect to obtain financial rewards through the gains from the acquisition.[106] In contrast, (other) dissatisfied shareholders in the target will typically (if they do not join their action with that of the bidder) seek an award of damages against the target board.[107] In relation to each, we consider that there is likely to be a structural bias which means that defendants—the target's board—are likely to reap a greater proportion of the expected benefits of successful litigation. This will, in turn, make both classes of plaintiff correspondingly more willing to settle, with the result that the precedents which persist will tend to be those which favour defendants.

The first point to note is that target boards have strong incentives, and deep pockets, to defend lawsuits. The incentives are given by the fact that they face significant loss of personal wealth if the lawsuit succeeds. This is most obviously the case in an action for damages. In an action for injunctive relief against defensive tactics, their financial losses will accrue from the

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[104] Bailey and Rubin, *id.*

[105] See Paul Rubin and Martin J. Bailey, 'The Role of Lawyers in Changing the Law', 23 J. Leg. Stud. 807 (1994).

[106] Examples drawn from the caselaw…

[107] Numerically, actions on behalf of dissatisfied stockholders greatly outnumber those by bidders: see Robert B. Thompson and Randall S. Thomas, 'The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions', 57 Vand. L. Rev. 133 (2004)

termination of their employment. Yet, given the prevalence of D&O insurance against personal liability, and golden parachutes as protection against employment termination, their most significant loss is likely to be reputational—that is, the depreciation of their human capital which will follow a lawsuit defeat. The board have deep pockets available to them in relation to such litigation because they are able to draw upon the company's resources to defend it.

Now compare the case of the jilted bidder. Recall that the bidder's financial interest lies in the gains to be realized from successfully gaining control of the target company, which litigation may achieve by forcing the target board to drop a defense. Yet an acquirer who succeeds in proving that the board's defensive tactics are illegitimate may fail to capture all the economic benefits thereby accruing. This is because there is nothing to stop a second bidder free-riding on the plaintiff's efforts and then swooping in on the now-defenseless target company with a slightly higher offer. Given this possibility, the bidder will discount the likely benefits from bringing a lawsuit accordingly. This may be expected to lead to a systematic bias against litigation by bidders. This is not to say that litigation will not occur, but rather that under-investment in litigation effort by bidders will lead to rules which tend to favour management of target companies, as compared with a system where the shareholders in effect write the rules for themselves. [Can we get data on proportion of unsuccessful hostile acquisitions which were litigated by bidders?]

Turning secondly to the case of dissatisfied stockholders: the very free-rider problems as between shareholders that make it economic to delegate corporate decision-making to directors also create a built-in asymmetry in any litigation to enforce directors' duties. In many jurisdictions, including the UK, this asymmetry manifests itself in a straightforward way: any individual shareholder has little to gain from prosecuting an action against directors, and stands to lose his investment in legal expenses if the outcome is unsuccessful.[108] In the US, of course, the derivative and class action mechanisms are designed to overcome these problems by aggregating many small claims so as to reap economies of scale in litigation expenditure. The problem with this is, however, that the free-rider problem now becomes not so much one of

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[108] See Virginia G. Maurer, Robert E. Thomas and Pamela A. DeBooth, 'Attorney Fee Arrangements: The US and Western European Perspectives', 19 Nw. J. Int'l L. & Bus. 272 (1999).

paying for the action, but of monitoring the agents—the plaintiffs' lawyers—who are appointed to prosecute it on their behalf. The 'plaintiff's bar' act rather like entrepreneurs, seeking out potential claims and then locating appropriate claimants *ex post facto*.[109] Plaintiffs' attorneys are interested in maximising fee revenue and minimising effort. It appears that this is not achieved by choosing good cases and litigating them to achieve damages awards. Rather, a 'shotgun' approach of filing many claims, related to readily observable indicia of possible malpractice, and relying on defendants to settle them so as to avoid the nuisance of litigation, maximises revenue and minimises effort. This prediction is borne out by a number of empirical papers which establish that the vast majority of US class actions appear to be unmeritorious.[110] Two recent studies of Delaware corporate class actions show that they concentrate on acquisition-oriented litigation, and that most disputes do not have merit.[111] Whilst many claims are brought, they are not claims which are capable of generating precedents for substantive liability rules that favour plaintiffs. Rather, plaintiffs' attorneys appear to litigate hard only on procedural issues which favour plaintiffs' attorneys.

We should be clear that the analysis we are applying here in relation to directors' duties concerning takeovers under Delaware law is not a specific criticism of Delaware, or indeed of the civil procedure in the US more generally. Rather, it follows simply from the use of common law adjudication to govern in this particular context. This claim may be further illustrated by considering the development of the common law in the UK in relation to takeovers. This was curtailed following the introduction of the City Code in 1968, but its content, as it evolved before then, reveals a strikingly similar pattern to that of Delaware law in the US.

The UK common law position on takeover defenses was principally developed by a series of cases in the 1960s and early 1970s.[112] These tended to be actions by bidders seeking

[109] John C. Coffee, 'Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions', 86 Colum. L. Rev. 669 (1986).

[110] Cites.

[111] See Thompson and Thomas, *supra* n 107; Robert B. Thompson and Randall S. Thomas, 'The Public and Private Faces of Derivative Lawsuits', 57 Vand. L. Rev. 1747 (2004); Elliot J. Weiss and Lawrence J. White, 'File Early, then Free Ride: How Delaware Law (Mis)shapes Shareholder Class Actions', 57 Vand. L. Rev. 1797 (2004).

[112] *Hogg* v. *Cramphorn* [1967] Ch 254; *Bamford* v. *Bamford* [1970] Ch 212; *Howard Smith Ltd* v. *Ampol*

injunctions, rather than target shareholders seeking damages, as the procedural obstacles put in place by English law for derivative actions are considerably more difficult to surmount than those in the US.[113] These cases each involved the target directors issuing shares to a friendly third party or a 'white knight' in order to forestall an announced bid. They established that it was illegitimate for directors to take actions which had the primary purpose of preserving their own control of the company, or of altering the balance of power in the shareholders' meeting.[114] Yet the jurisprudence also made clear that actions which were motivated primarily by a legitimate business purpose, and had a merely incidental effect of frustrating a bid, would not constitute a breach of duty.[115]

Moreover, the facts in these cases were quite extreme: most involved the issue of fresh shares to dilute the holding of an acquiror *after* the acquiror had secured voting control of the target's general meeting. Had the directors acted with greater alacrity, before the bidder had secured control, then it would have been more difficult to argue that they were interfering with the control of the general meeting. This would be particularly so if they formed the opinion, with some objective evidence to support it, that the bidder's plans for their company were not in its

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Petroleum Ltd [1974] AC 821 (a case relating to facts occurring in Australia and heard in the UK before the Privy Council, then the highest court of appeal in that jurisdiction).

[113] A plaintiff seeking to bring a derivative action must show (i) a *prima facie* case that the defendant's conduct constituted a particularly serious beach of duty (i.e. a 'fraud on the minority'); (ii) that the wrongdoers control the company (*de jure* or *de facto*); and (iii) that they are a fit and proper person to represent the other shareholders in the action. Moreover, a derivative action will be barred if the company's claim has been legitimately compromised by an independent organ of the company, or if a majority of the minority shareholders wish it not to proceed. Unsurprisingly, the instances of derivative litigation under English law are very few.

[114] *Howard Smith*, *supra* n 112, ???-???.

[115] Two Commonwealth decisions were cited by the Privy Council in *Howard Smith* as examples: see *Harlowe Nominees Pty Ltd* v. *Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 (High Court of Australia) (primary purpose of issuing shares was business purpose of raising capital: legitimate notwithstanding it had necessary effect of diluting hostile acquiror's holding); *Teck Corporation* v. *Millar* (1972) 33 DLR (3d) 288 (Supreme Court of British Columbia) ('lock-up' deal involving issue of shares to counterparty found to have been effected with primary purpose of securing for company most favourable terms for deal and therefore legitimate, notwithstanding that it had the necessary consequence of frustrating hostile acquisition).

interests. This point was made expressly by Sir Robert Megarry, VC in *Cayne* v. *Global Natural Resources plc*:[116]

> "If company A and company B are in business competition, and company A acquires a large holding of shares in company B with the object of running company B down so as to lessen its competition, I would have thought that the directors of company B might well come to the honest conclusion that it was contrary to the best interests of company B to allow company A to effect its purpose, and that in fact this would be so. If, then, the directors issue further shares in company B in order to maintain their control of company B for the purpose of defeating company A's plans and continuing company B in competition with company A. I cannot see why that should not be a perfectly proper exercise of the fiduciary powers of the directors of company B. The object is not to retain control as such, but to prevent company B from being reduced to impotence and beggary, and the only means available to the directors for achieving this purpose is to retain control. This is quite different from directors seeking to retain control because they think that they are better directors than their rivals would be ..."

This formulation does not seem substantially different to the 'just say no' defense that some observers believe has been accorded to directors under Delaware law since *Time Warner*.[117] These issues were recently considered again by the Court of Appeal in the context of a very onerous lock-up agreement,[118] which gave the counterparty an extremely generous option to purchase key assets following any change of control in the target company. At first instance, Hart J held that entering into such an agreement would be a breach of directors' duties because its effect, if ever enforced, would necessarily be to harm the company.[119] The Court of Appeal thought this formulation too narrow. Carnwath LJ, who gave the leading judgment, was prepared

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[116] Unreported (1982), cited at first instance by Hart J in *Criterion Properties plc* v. *Stratford UK Properties LLC* [2002] 2 BCLC 151, 162-3.

[117] See Paul L. Davies, 'The Regulation of Defensive Tactics in the United Kingdom and the United States' in Klaus Hopt & Eddy Wymeersch (eds.), *European Takeovers: Law and Practice* (London: Butterworths, 1992), 195, 207-10; [Weingberg & Blank]; Blanaid Clarke, 'Regulating Poison Pills' 4 J. Corp. L. Stud. 51, 61-67 (2004).

[118] It was referred to in the case as a 'poison pill', in form it was closer to the arrangements known as 'lock-ups' in the US.

[119] *Criterion Properties plc* v. *Stratford UK Properties LLC* [2002] 2 BCLC 151, 164.

to concede that a lock-up might be justifiable in the face of a hostile acquirer who plausibly threatened the company's existing business, but felt that the arrangement in question was disproportionate in its response to the perceived threat: it took effect not just in relation to the particular bidder, but in relation to any change in the management of the company.[120] In other words, it smacked of entrenchment. This formulation is again, strikingly similar to the proportionality test employed by Delaware courts in reviewing directors' conduct under *Unocal*.

Given that using litigation to resolve such matters involves a structural bias in favour of the directors, it should not be surprising that UK institutional investors chose to 'privatise' the matter by instituting the Takeover Code in the late 60s. What is more surprising, however, is that their counterparts in the US did not. This, as we have explained,[121] is a result of federal legislation which prevented institutional investors from developing sufficiently close links with one another to make collective action on this scale feasible in the US, together with federal regulation that displaced an earlier tradition of self regulation in the securities markets. There is an irony, therefore, in calls for federal legislation to remedy the perceived 'problem' of Delaware takeover law, when in our view it is Federal legislation that is fundamentally responsible for the perceived problem.

V. WHICH SYSTEM IS BETTER?

Our analysis thus far has been purely positive: we have been seeking to explain *why* the rules governing takeovers in the US and the UK evolved in such different directions. In order to understand the implications of this analysis for policy-makers, however, it is necessary to turn to the overtly normative question of which system is better. As with the rest of our analysis, we

[120] *Criterion Properties plc* v. *Stratford UK Properties LLC* [2002] EWCA Civ 1783, [2003] 1 WLR 2108 at [26]. The case was appealed to the House of Lords who decided it on different grounds: [2004] UKHL 28, [2004] 1 WLR 1846.

[121] *Supra*, section IV.B.

address this at two levels: in terms of procedure and of substance. Because it is a central claim of this paper that the former may influence the latter, the partition between them in this section—adopted for expositional purposes—is not watertight.

A) Process

In assessing the comparative merits of the UK's informal regulation of takeovers with the use of litigation in the US, this part first considers static efficiency—that is, the comparative costs of effecting control transactions under the two systems—and then turns to dynamic considerations—namely, the two systems' capacities to respond and adapt to changing practices in the marketplace.

(i) Static effects

In the governance of any given takeover transaction, we consider that the UK's system has advantages in terms of speed, costs, and certainty. Consider first speed. The City Code prescribes a strict timetable for the conduct of bids, in order to minimise the amount of time for which the uncertainty of a takeover battle may surround the target company.[122] This principle is reflected both in the City Code itself and in the Panel's practice, throughout the bidding process. Thus, in order to minimise the uncertainty that occurs when a company is 'in play', the City Code requires that a bidder which has expressed a firm intention to make an offer must follow this with a formal offer within 28 days.[123] Once a formal offer has been made, the Code prescribes that it may not usually remain open for more than 60 days unless it has been declared unconditional as to acceptances.[124] Again, to minimise uncertainty, a party which has made an unsuccessful bid may not make another hostile bid for the same target within 12 months.[125]

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[122] relevant Rules.

[123] If a potential bidder strategically announces that it is considering making a bid, the potential target may ask the Panel to issue a so-called "put up or shut up" notice to the potential bidder to resolve the uncertainty—that is, to announce one way or the other whether it will be making a bid: see The Takeover Panel, Code Committee Consultation Paper: "Put Up or Shut Up" and No Intention to Bid Statements, PCP 2004/1 issued 25 February 2004.

[124] An offer which is declared unconditional must remain open for at least a further 14 days from the date when this occurs. The announcement of a second bid will reset the timetable for the first bidder in order to give it

Consistently with this goal of resolving bidding situations quickly and with minimum uncertainty, takeover-related litigation is ruled out. The Panel will usually prohibit the target board from commencing legal action without shareholder consent where it may be expected to have the effect of frustrating a bid, regardless of the perceived merits of the claim in question.[126] Whilst the Panel's decisions are technically subject to judicial review,[127] a challenge on this basis could not be used to affect the result of a takeover, as the English courts, concerned not to interfere with the Panel's 'real-time' decision making, have made clear that relief, if ever granted, will be declaratory regarding future conduct and will not have any consequences for the validity of decisions which have been taken.[128]

In the US, there are no such restrictions on how long an offer may remain open, a competitive situation may continue, or indeed on repeated bids for the same target. Furthermore, resort to litigation is a defensive tactic frequently employed by target boards.[129] It is therefore not surprising that a typical M&A deal in the US takes approximately five months to complete,[130] and that the period is usually considerably longer for hostile acquisitions.[131]

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time to respond by raising its price. However, where a competitive bidding situation has not been resolved within 46 days of the second offer, the parties must move to an accelerated open auction procedure, in order to minimise the time for which the target is "under siege": see The Takeover Panel, Code Committee Consultation Paper: Resolution of Competitive Situations, PCP7 issued on 16 October 2001.

[125] City Code, Rule 35.1.

[126] WEINBERG & BLANK, 4-7114 - 4-7130B.

[127] *R.* v. *Panel on Takeovers and Mergers, ex parte Datafin plc* [1987] QB 815.

[128] *Id.*, 841-42. It should be noted that this precedent is consistent with the theory articulated in section IV.C: the Takeover Panel, representing the interests of the institutional investor community of the City, can be expected to litigate aggressively to defend the effectiveness of its jurisdiction to oversee disputes.

[129] [CITE to recent examples. Did PeopleSoft itself initiate any of the litigation against Oracle?]

[130] See David A. Becher & Jennifer L. Juergens, Influencing Merger Outcomes: The Role of Investment Analysts in Merger Success, Working Paper Drexel University/Arizona State University, October 2004, 27 (Table 1: average time to completion for sample of US M&A deals during period 1993-2000 was 146 days).

[131] William C. Hunter & Julapa Jagtiani, *An Analysis of Advisor Choice, Fees, and Efforts in Mergers and Acquisitions*, 12 J. Fin. Econ. 65, 74-76 (2003) (reporting results for sample of M&A deals during 1995-2000: hostile tender offers typically take longer to complete than friendly deals).

Now consider costs. Litigation is an expensive way of resolving disputes. In contrast, a significant proportion of the regulatory issues in the UK are resolved by no more than a telephone call to the Panel Executive. In contrast to the services of litigation lawyers, the Panel does not charge for the issuance of such guidance. Rather, its operations are funded by a fee charged in relation to formal offers,[132] a small levy paid on significant dealings in shares on the London Stock Exchange,[133] and by sales of the City Code.[134]

To our knowledge, no direct evidence currently exists on the comparative level of legal advisor fees incurred in the two jurisdictions.[135] However, it is a well-known fact that US firms with an M&A oriented practice generate significantly more revenue per lawyer than do their UK counterparts. For example, Slaughter and May, arguably the leading M&A firm in the UK, generated gross revenues per lawyer of £433,000 and profits per equity partner of £778,000 during 2003-4.[136] In contrast, during the same period the comparably-sized US M&A firm of Sullivan & Cromwell generated gross revenues per lawyer of £649,000 and profits per equity partner of £1,163,000.[137] While these profit figures do not speak directly to differences in the litigation costs of US and UK merger practice, since law firms provide a wide range of services

[132] A 'document charge' is levied by the Panel on the issue of formal offer documentation in relation to offers exceeding £1m in value. It is set at a declining marginal rate, starting at 0.2% of the value of an offer over £1m, and falling to below 0.02% of the value of offers over £1bn (Appendix to City Code on Takeovers and Mergers, 'Document Charges').

[133] The levy is £1 on any purchase or sale of shares in excess of £10,000 (London Stock Exchange, Panel on Takeovers and Mergers—PTM Levy, Stock Exchange Notice N07/02, 7 March 2002). See also

[134] See, e.g., Takeover Panel, *Report and Accounts for the Year Ended 31 March 2005,* 16.

[135] None of the major M&A databases, such as Thomson's SDC Platinum, Bloomberg or Mergermarket, contain detailed records of legal fees for a significant proportion of their coverage. This is, we suspect, because in the US, such fees may be capitalised as part of the cost of the acquisition, meaning that they are effectively hidden from view. New tax rules coming into force on 1 January 2006 will change this [JA to expand and support this claim].

[136] THE LAWYER, THE LAWYER GLOBAL 100 (November 2004).

[137] *Id.* The most profitable M&A firm of all is also based in New York. During the same period, Wachtell, Lipton, Rosen & Katz generated gross revenues per lawyer of £1,111,000 and profits per equity partner of £1,582,000.

in addition to corporate M&A, they are entirely consistent with the conclusion that the US system is considerably more expensive for parties to a takeover. Diversified shareholders would surely prefer a cheaper system of regulating takeovers, as it is well-understood that commercial parties who are repeat players may be expected to care a great deal about the costs of dispute resolution.[138]

The relative certainty of the two systems is closely related to the foregoing points. One of the objectives of the UK regime is to foster certainty in the resolution of disputes concerning takeovers. The most important mechanism for achieving certainty is the provision of 'real time' guidance. Parties are encouraged to seek authoritative guidance from the Panel Executive on any potential issue at the earliest stage possible. Thereafter, the party may proceed with certainty. At a more general level, the restricted timetable for the conduct of bids seeks to minimise uncertainty about the outcome of bids as quickly as is possible consistently with the fair treatment of shareholders. In contrast, reliance on precedent in the US can lead to significant uncertainty in parties' understandings about what conduct is acceptable, and resort to litigation can result in extended delays to the resolution of a particular takeover battle. [139]

(ii) Dynamic effects

The differences between the two systems extend beyond the resolution of individual takeover situations. Perhaps even more significant are the dynamic effects—that is, the way in which the two regulatory regimes change over time. One aspect concerns their respective ability to respond to changes in the marketplace. The UK's 'soft law' regulatory regime regulatory is proactive in its response to market developments. The Code Committee of the Takeover Panel meets several times a year to discuss the operation of the market, assess recent developments and determine whether any amendments to the City Code are necessary in response.[140] In contrast,

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[138] Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 Yale L.J. 541 (2003).

[139] [Add a reference to PeopleSoft or the MCI battle?].

[140] Cite to Panel Annual Reports detailing frequent meetings of Code Committee.

US courts make rules in a way that is essentially reactive: changes in the marketplace lead to litigation, following which, the courts pronounce upon acceptable behaviour.

Interestingly, the Delaware courts have adapted the traditional litigation process to counteract its limitations in several important respects. First, Delaware's generosity in awarding attorney's fees to the lawyers for shareholder plaintiffs assures a steady stream of cases to the Delaware courts. Moreover, even when it concludes that the directors did not breach their duties, the chancery court often critiques the director's performance, offering guidance to directors who will be dealing with similar issues in the future.[141] Finally, the six Delaware chancery judges frequently compare notes, often over lunch, about emerging corporate law issues, which enables them to begin mulling over new developments long before a particular dispute arises. Despite these remarkable adaptations, it remains true that the Delaware courts cannot take action until an actual controversy arises.

However, to focus solely on the role of courts in the US is to exaggerate the differences between the two regimes. In an environment of common law regulation, the role of 'updating' the regime falls in the first instance to legal advisers, who interpret the existing precedents in light of market developments, and give professional advice to their clients as to what is and is not acceptable. This may lead to some variation in the interpretations, and in due course litigation may follow, but it is not to say that the system does not respond rapidly to changes. Given the subtleties of the differences, it may therefore be helpful to consider a case study of their responses to an issue which has recently led to controversy in takeover disputes on both sides of the Atlantic.

In a number of recent takeover disputes, bidders have sought to acquire or influence control of a target without triggering disclosure obligations by using contracts for differences ('CFDs'). CFDs—known as equity swaps in the US-- are a bilateral contract under which the holder essentially takes a bet against a financial institution counterparty on the price of an underlying security. For a 'long' CFD, the holder bets on a rise in price, and for a 'short' CFD, on a fall. As part of its hedging strategy for a long CFD, the counterparty will typically acquire

[141] These attributes of the Delaware courts are explored in detail in Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

the underlying security, a transfer of which it is common for a purchaser to accept in settlement of a long position. Because the institution will be fully hedged, it has no financial interest the underlying security during the currency of the CFD. However, it nevertheless holds the voting rights, and if it has an ongoing relationship with the holder, may well be favourably disposed to exercise these rights in accordance with the wishes of the holder. Thus the holder of a long CFD may in practice be in a position to exercise voting control of the underlying shares without having any beneficial interest in them. Such arrangements have in several recent instances been used by bidders in order to acquire control of targets without triggering disclosure obligations.

In the US, this strategy achieved notoriety in 2005 in connection with a proposed acquisition by Mylan, a pharmaceutical company, of King, another pharmaceutical. Perry Corp., a hedge fund that held a substantial stake in King, bought and simultaneously hedged 9.9% of Mylan's stock.[142] In effect, Perry bought 9.9% of the Mylan votes, in an effort to tip the Mylan vote in favor of the acquisition so that it could profit from acquisition of its King shares. Perry's gambit (later abandoned after Carl Icahn, another Mylan stockholder, sued) brought the new vote buying technique and the potential for abuse to public attention.

The response of the UK Takeover Panel's Code Committee has been to propose amendments to the City Code and the SARs which will, in essence, provide for the treatment of long CFDs and other derivative contracts capable of generating the same consequence (including spread bets) in a manner similar to the acquisition of the underlying securities.[143] Extensive public consultation is now under way, and changes in the rules are expected shortly. In the US, by contrast, the response has been much slower. There are hints of activity at the SEC—including an investigation of Perry that seems likely to lead to an enforcement action—but the

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[142] The Perry episode is described and criticized in David Skeel, *Behind the Hedge*, LEG. AFFAIRS, Nov/Dec 2005, at 28, 29-30 (emphasizing that Perry's economic incentives were diametrically opposed to the interests of other Mylan shareholders—the more overpriced the acquisition, the more Perry would have profited due to its stake in King). For a thoughtful and extensive analysis of the new vote buying techniques, see Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and Decoupling of Economic and Voting Ownership in Public Companies* (unpublished manuscript, Jan. 6, 2006)..

[143] Code Committee of the Takeover Panel, *Dealings in Derivatives and Options: Outline Proposals*, Panel Consultation Paper 2005/1, 7 January 2005; Code Committee of the Takeover Panel, *Dealings in Derivatives and Options: Detailed Proposals Part 1: Disclosure Issues*, Panel Consultation Paper 2005/2, 13 May 2005.

SEC probably could not promulgate a substantive rule aimed at the new vote buying unless Congress first amended the securities laws to give the SEC the authority to step in.[144] There also is no evidence that Delaware will intervene anytime soon.[145]

Important as these differential responses may be, there may be a yet more significant difference flowing from the choice of the mode of regulation. A central claim of this paper, which we have elaborated in section IV.C, is that the substance of the regulatory regimes will, over time, come to reflect the interests of those who are best positioned to influence their content. In the context of takeovers, we suggest that court-centred rule-making will tend to result in rules that favour managers (the US case), whereas the UK's soft law regime, driven by institutional investors, reflects rather the interests of institutional shareholders. To see whether this has significant implications for policymakers, it is therefore necessary to compare the merits of the substantive regulation in each system.

B) Substance

As we have seen, the two systems may be crudely contrasted as reflecting differing philosophies about who should make the ultimate decision about the success or demise of a corporate courtship. The UK promotes shareholder choice, whereas the US permits board discretion. The discussion that follows briefly reviews the extensive debate over the two perspectives. Although neither is indisputably superior, there is reason to be skeptical of an approach that gives target managers broad discretion to resist takeovers.

(i) Value-increasing motives for takeovers: synergies and managerial discipline

As discussed at the outset of Part II, a takeover will be socially beneficial if the bidder can use the target's assets more productively than can that target's incumbent management.[146]

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[144] The SEC could, however, use its existing authority to require more disclosure of derivatives based vote buying. For a proposed disclosure framework that would achieve this effect, see Hu & Black, *supra* note [xx]. Disclosure-based regulation seem likely to be the principal US regulatory response, but the SEC had not even begun the rulemaking process as of this writing.

[145] *See, e.g., id.* at 35 (noting that Perry's vote buying does appear to violate the Delaware prohibition against vote buying because Perry did not directly purchase votes).

This could either be because there may be synergies to be exploited between the bidder's and the target's business, or, more basically, because the target's management are underperforming. The latter, 'disciplinary', function is the idea underpinning the 'market for corporate control'. The disciplinary properties of the threat of a hostile bid, and the incentives this gives to managers to focus on 'shareholder value', are well understood both by market participants and policymakers.[147]

If all—or even most—takeovers were motivated by the foregoing concerns, then the policy implication would be straightforward: the regulatory environment should facilitate hostile bids to the greatest extent possible, as does the UK's City Code.[148] But are things quite so straightforward?

The vast empirical literature seeking to determine whether or not takeovers tend to be value-increasing has generated one stylised fact of which we can be reasonably confident: target shareholders fare well following a hostile bid. What is less clear, however, is whether these gains come from increased operating or managerial efficiencies following the takeover, or are at the expense of other groups—including, perhaps most plausibly, bidder shareholders. Thus whilst some studies on both sides of the Atlantic have reported evidence supporting the 'disciplinary' hypothesis for takeovers, many others have failed to find any.[149]

However, the policy implications are ambiguous. Superficially, it might be claimed that the costs of value-decreasing bids might be reduced by making hostile bids more difficult—that is, by a system which gives target management a greater degree of freedom to erect defences. Yet this seems to be putting the cart before the horse. If hostile takeovers are thought to be a discipline for excessive managerial agency costs, and bidder overpayment is a manifestation of such costs, then the most effective way to solve the problem is to facilitate bids: bidder

[146] Romano 1992

[147] See, e.g., [quote from Simon Deakin's interview with FTSE 100 director about hostile TO being the 'great white shark']; cite to DTI 1988 policy paper about takeovers and the public interest.

[148] Bebchuk and Ferrell's support for City Code.

[149] Cites.

management will be constrained by the fear that an unsuccessful takeover will then put the combined business in play, with the consequent loss of their own jobs.

In the light of such inconclusive evidence, it is appropriate to consider in more detail the various market failures that may lead to the consummation of value-decreasing takeover deals, and to assess how the two regulatory regimes under consideration fare in responding to them. In the presence of such market failures, the optimal policy is not one designed only with the goal of facilitating bids, but rather is one which seeks to facilitate only *value-increasing* bids.

(ii) Coercive bids

First, the decisions of target shareholders whether or not to accept a bid may be systematically biased if the bid is 'coercive'. That is, a partial bid may subject target shareholders to a prisoner's dilemma.[150] They will feel pressured into tendering, even if they consider the bid is set at a price worth below that which their shares are worth, if they fear that if they do not accept, they will be faced with the unpleasant consequences of being cashed out at an even lower price or winding up as a minority shareholder in a company controlled by the bidder.[151]

Both the Williams Act and the City Code seek to restrict the ability of a purchaser to effect a coercive bid. Thus, under the Williams Act, a tender offer must remain open for at least 20 days, and the bidder must purchase *pro rata* from all shareholders who accept the offer. The price paid must be the highest at which the acquirer has bought the target's stock during the tender offer period. These provisions are designed to ensure that no stockholder feels pressured into accepting a bid in haste by the fear that if they do not, they will end up as a minority shareholder in the target company, or that they will not receive the most advantageous terms. Conversely, stockholders are also permitted to change their mind should they decide to withdraw their acceptances at any point before the bid is complete.

The City Code, however, goes rather further in ensuring that target shareholders are not coerced, although at the risk of chilling bids on the margins. Similar to US law, it requires that a

[150] Bebchuk (1985?)

[151] Footnote about free-rider problem (Grossman & Hart, 1982)?

bid remain open for at least 21 days. However, the consideration paid must be equal to the highest price paid by the acquirer for that stock during the previous 12-month period. The most significant protection, however, is the way in which the Code effectively prevents a partial bid from being made. First, it compels the acquirer to purchase not just *pro rata*, but *all* shares tendered by target stockholders during the bid period. Secondly, the mandatory bid rule requires any person or group of persons acting in concert who acquire more than 30% of a listed company's voting stock to make a bid for the entire shareholding of the company. This is intended to prevent a change of control occurring otherwise than by a tender offer open to all shareholders.[152]

Thus far, it seems the City Code does a better job of deterring coercive bids. Yet this fails to take into account the role played by defensive tactics. Martin Lipton, one of the earliest and most persuasive advocates of defensive tactics in the US, has long claimed that they are an appropriate deterrent to 'abusive' bidding practices.[153] Under *Unocal*, Delaware Courts permit target management to refuse to redeem a poison pill where there are objective reasons for viewing this as a proportionate response to a threat—such as coercion-- to the company's well-being posed by the bid.[154] This will then force a bidder to either alter the bid or to engage in a proxy contest—functionally equivalent to the role played by a shareholder vote in authorising

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[152] In addition, both jurisdictions provide for disclosure of significant shareholdings, so as to prevent bidders from taking target shareholders by surprise. In the US, the Williams Act requires that a party gaining control of more than 5% of a listed company's voting stock must disclose this fact, along with details of any parties with whom they are acting in concert, a statement of their purpose and intentions in relation to control of the company, and details of how their acquisition has been funded. UK legislation requires any person (or group of persons acting in concert) holding more than 3% of a public company's voting shares to disclose that fact, and additional purchases must be disclosed at each percentage point (Companies Act 1985 s 198.) In addition, the Rules Governing Substantial Acquisitions of Shares ('the SARs'), which have the same 'soft law' status as the City Code, restrict the speed with which a potential bidder may aggregate a significant block of shares in a listed company.

[153] Lipton 1979; 1985; 2003?

[154] The classic "threats" that justify target managers' use of defensive tactics under Delaware law are coercion and inadequate price. Delaware made clear in *Paramount Communications inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989), however, that a wide range of other threats would also be countenanced by the Delaware courts.

defensive tactics in the UK.[155] Seen in this light, then, both systems appear to trade off less bids against the benefit of removing the prospect of decisional error through coercive bids.[156]

(iii) Stakeholder expropriation

Another commonly-cited concern with takeovers is that they may 'create' wealth for stockholders at the expense of other constituencies: most saliently, creditors and employees.[157] Creditors, for example, may find the face value of their claims suddenly deflated by the target's having taken on a heavy debt burden to finance the acquisition or subsequent restructuring.[158] Or employees, who have made investments in firm-specific human capital on the faith of implicit promises of job security, may find themselves representing simply an operating cost to the bidder, and be given their walking papers.[159] In each case, a purely redistributional bid may succeed, which simply transfers wealth from these constituencies to shareholders.

Such concerns are taken relatively seriously in the US. Most notably, the 'constituency statutes' in a number of jurisdictions expressly permit managers to take into account the interests of employees in deciding whether, and to what extent, to take defensive action against a hostile bid. Delaware does not explicitly permit this, but the protection of employees may certainly be a justification for the board's bona fide decision that the current business plan should be preferred to that proposed by the offerer.

In contrast, employee concerns can never be a ground for post-bid resistance in the UK. The City Code is focused solely on the interests of shareholders. If managers consider that the bid would be detrimental to the interests of employees, then they may convey this information to shareholders to be taken into account in their decision whether or not to accept the bid, but the ban on defensive action prohibits them from doing anything more about it.

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[155] Gilson & Schwartz; Bebchuk & Hart,

[156] Whether this trade-off is optimal is a matter for debate, but one that it beyond the scope of the present analysis, which is simply concerned to compare the two existing systems. See, e.g., Burkhart

[157] Discussion of the plight of Manchester United fans?

[158] McMorey, 1986; Bratton 1988. RJR Nabisco

[159] Shleifer & Summers, 1988; Blair, 1995; Deakin and Slinger, 1997.

Turning to the empirical evidence, it seems relatively clear that hostile acquisitions in the UK tend to be followed by substantial job losses for target employees.[160] Conversely, US takeovers do not seem, on aggregate, to result in net reductions of employment levels.[161] Yet care should be exercised in interpreting these findings. Because the UK has much more rigid labour markets than the US, the greater job losses may simply reflect efficient restructurings, as opposed to breaches of trust.[162] In contrast, studies which specifically exploring whether breaches of trust have followed takeovers have found evidence of this in the US but not in the UK.[163]

(iv) Asymmetric information

A bid may also be accepted in error if the target's stock price is not the best reflection of the expected value to shareholders of the current management's business policy.[164] Most

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[160] M.J. Conyon, S. Girma, S. Thompson and P.W. Wright, 'The Impact of Mergers and Acquisitions on Company Employment in the United Kingdom' (2001) 46 *European Economic Review* 31 (takeovers during period 1967-1996 result in significant job losses for acquirers); S. Deakin, R. Hobbs, D. Nash and G. Slinger, 'Implicit Contracts, Takeovers and Corporate Governance: In the Shadow of the City Code' University of Cambridge Centre for Business Research WP 254 (2002) (case study evidence of hostile takeovers leading to significant job losses over time).

[161] K. Gugler and B.B. Yurtoglu, 'The Effects of Mergers on Company Employment in the USA and Europe' (2004) 22 *International Journal of Industrial Organization* 481 (Sample of mergers from 1981-1998: US mergers on average result in slight increase in employment; UK mergers result in significant decrease).

[162] *Ibid.* Indeed, evidence from the US suggests that mergers have a differential impact upon employees in different industries: with high-tech mergers resulting in increased employment, but 'old economy' mergers resulting in job losses: see B.H. Hall, 'Mergers and R&D Revisited' Working Paper prepared for Quasi-Experimental Methods Symposium, Econometrics Laboratory, US Berkeley, 1999.

[163] Compare J. Gokhale, E.L. Groshen and D. Neumark, 'Do Hostile Takeovers Reduce Extramarginal Wage Payments?' (1995) 77 *Review of Economics and Statistics* 470 (finding that US hostile takeovers reduced extramarginal payments, a proxy for implicit contracts involving sharing quasi-rents, to target employees) with T. Beckmann and W. Forbes 'An Examination of Takeovers, Job Loss and the Wage Decline within UK Industry' (2004) 10 *European Financial Management* 141 (sample of UK takeovers during 1987-1995; no evidence found that they involved a 'breaches of trust' for target employees).

[164] See Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 Nw. U. L. Rev. 521 (2002).

financial economists now concede that capital markets are not 'strong form' efficient. That is, securities prices at best impound only *publicly-available* information about the firm's prospects. In this situation, if the incumbent management have private, positive, information about the firm's prospects under their current strategy, then the stock price may undervalue the firm, and a takeover which succeeds because the bidder offers more than the current stock price may actually be value-decreasing.

The notion of asymmetric information between target management and its shareholders may be thought to offer a justification for the use of defensive tactics.[165] This would go beyond the early Delaware decisions which legitimated the use of poison pills to deter 'abusive' bids, and extend to the implementation of the 'just say no' defense outlined in *Time Warner*, whereby target management may refuse to accept a bid simply based on their bona fide belief in the inherent superiority of their existing business strategy.[166] This justification is subject to at least two possible objections. First, if a company's stock price fails to reflect the value of important private information held by the company's managers, the obvious solution is for the managers to reveal the relevant information to the market. On this view, the shareholders can then decide for themselves whether or not the bid accurately values the securities. In the UK environment, where frustrating action is prohibited, the most powerful defense for target managers is said to be the revelation of positive information about the business' expected performance.[167] However, this claim is belied by an empirical study which finds no evidence that managers in UK target

[165] Lipton & co-authors; Black and Kraakman (2002)

[166] Marty Lipton has long defended this position. Recent work by Richard Kihlstrom and Michael Wachter has developed a new justification for managerial discretion. Kihlstom and Wachter argue that managers may be forced to "manage to the market" under a shareholder choice regime that vests ultimate authority over takeover bids in the hands of shareholders. *See, e.g.*, **Error! Main Document Only.**Richard E. Kihlstrom & Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law*, 152 U. PENN. L. REV. 523 (2003). Kahan and Rock have suggested that managers may have better information as to whether a takeover auction (which shareholder choice requires) or a negotiated sale will bring the highest price in a sale. Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PENN. L. REV. 473 (2003).

[167] See, e.g., George O. Barboutis, *Takeover Defence Tactics: Part 2—Specific Defensive Devices*, 20 Com. Law. 40, ??-?? (1999); WEINBERG AND BLANK, 4167-68.

companies are able to introduce new information in their defense documentation which will materially affect the outcome of a bid.[168]

A second, more familiar objection applies even if the distortion may stem from information that cannot easily be revealed to the market. Investors may value some kinds of projects more highly than others, for instance, which suggests that managers may be forced to pursue the kinds of projects that shareholders prefer, lest their company's share price wallow and the company be susceptible to a takeover, even if the managers rightly believe that another kind of project is more promising in the longrun.[169] The problem with this reasoning is that, while permitting managers to fend off takeovers might facilitate promising projects in some cases, in other cases it simply insulates them from the discipline of the takeover market. Resistence to takeovers quite frequently seems to reflect the latter—agency costs—rather than the former.

(v) Inefficient capital markets

The greater the doubts which are entertained about the efficiency of capital markets, of course, the more fundamental are the concerns about decisional error. If capital markets are not even efficient in the semi-strong form, but actually misprice securities because of a bias towards short-termism on the part of investors, then hostile takeovers may result in a systematic misallocation of capital away from long-term and in favour of short-term projects.

What has long been folk wisdom is now becoming increasingly accepted amongst finance scholars: that capital markets are subject to speculative bubbles, during which stock prices bear no resemblance to underlying value. This effect is due to the presence of short-term momentum investors, in addition to long-term value investors.[170] In keeping with this claim, studies show that merger activity is strongly cyclical in its orientation.[171]

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[168] T.E. Cooke, R.G. Luther and B.R. Pearson, 'The Information Content of Defence Documents in UK Hostile Takeover Bids' (1998) 25 *Journal of Business Finance and Accounting* 115 (information revealed in defence documents of sample of hostile bids during period 1988-1990 has no significant effect on likelihood of bid succeeding).

[169] Kihlstrom & Wachter, *supra* note [xx].

[170] Shleifer, Bratton; In the specific context of takeovers, see José-Miguel Gaspar, Massimo Massa and Pedro Matos, *Shareholder Investment Horizons and the Market for Corporate Control*, 76 J. Fin. Econ. 135 (2005)

(vi) Interplay of corporate governance and defensive tactics

To summarize the story so far, defenders of the US' board discretion regime argue that defensive tactics may facilitate a board in deterring bids which are value-decreasing—whether because they are coercive, fail to reflect private information held by target managers, likely to impose costs on stakeholders that exceed the benefits to stockholders, or simply reflect inefficiencies in the capital markets which bias bidders towards short term concerns. A recurrent problem with this justification is that it appears to set the fox to guard the hen-house: the target board, the very group whom hostile takeovers are thought to discipline, are vested with the authority to decide whether or not a bid is likely to be harmful or beneficial to the target business.

Kahan and Rock, in an important series of recent papers, have drawn attention to the importance of board structure in addressing this apparent paradox. Where the board are subject to other governance mechanisms which encourage them to work in shareholders' interests—most notably, appropriately designed compensation packages giving them a strong interest in the company's share price, and a preponderance of non-executive directors as overseers of the executives' decisions, then the shareholders may be more confident that this *ex post* power will be exercised in accordance with their interests.[172] This claim receives some support from Moeller's recent empirical study comparing board structure and takeover premiums in the US. It

(targets with short-term shareholders—that is, those whose shareholder tend to hold their stock on average for less than four months—are more likely to receive an acquisition bid but at a lower premium, compared to targets with longer-term shareholders).

[171] See, e.g., Klaus Gugler, Dennis C. Mueller and B. Burçin Yurtoglu, The Determinants of Merger Waves (Working Paper, University of Vienna, 2004) (concluding that merger waves are driven primarily by overvaluation of bidder shares permitting them to be used to fund acquisitions, and/or bidder management empire-building).

[172] Kahan and Rock's insights are similar in some respects to the arguments of scholars who have emphasized the importance of directorial discretion generally. The two most prominent advocates of board discretion are Steve Bainbridge and Lynn Stout. *See, e.g.,* Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 Stan. L. Rev. 791 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. (2002); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999).

reports that, where a staggered board structure has been adopted, if the board is controlled by independent directors, a significantly larger premium is obtained for target shareholders in the context of a takeover.[173] Thus takeover defences coupled with an independent board can be a powerful force acting in the interests of shareholders.[174]

Here, too, however, there are grounds for caution. Although managerial compensation can counteract managers' incentive to resist takeovers, for instance, it also may introduce distortions. As became clear with the US corporate scandals, heavily options-based pay gives managers an incentive to drive up the company's stock price in any way possible, since managers profit if the price rises but aren't punished if it falls.[175] If managers are given significant amounts or stock and/or a lucrative golden parachute, they may have too great an incentive to accede to (or even to seek out) a takeover. Independent directors may counteract these incentives to some extent, but they invariably operate at a disadvantage in dealing with managers who have far more information about the company and its prospects.

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[173] T. Moeller, 'Let's Make a Deal! How Shareholder Control Impacts Merger Payoffs' (2005) 76 *Journal of Financial Economics* 167, 186.

[174] In the UK, a well-functioning independent board appears to make a friendly acquisition more likely than a hostile one, and also to increase the mount of the bid premium which is enjoyed by the target shareholders (see J. Dahya and R. Powell, 'Ownership Structure, Managerial Turnover and Takeovers: Further UK Evidence on the Market for Corporate Control' (1998) 2 *Multinational Finance Journal* ??: hostile targets have significantly less managerial share ownership than friendly targets; N. O'Sullivan and P. Wong, 'Internal versus External Control: An Analysis of Board Composition and Ownership in UK Takeovers' (1998) 2 *Journal of Management and Governance* 17: hostile targets exhibit significantly less managerial share ownership, and significantly less duality of CEO/Chairman roles, than do friendly targets and non-targets). That is, managers with little financial stake in the company are more likely to seek to defend a bid so as to retain their jobs, but in so doing they are likely to forego benefits which might be obtained for their shareholders through more effective negotiation in the context of an agreed deal (C. Th. Constantinou and C. Th. Constantinou, 'The Effect of Board Structure on Bidder-Shareholders' Wealth: Further Evidence from the UK Bidding Firms', University of Cambridge ESRC Centre for Business Research Working Paper No 261 (2003): very small or very high numbers of non-executives on target board result in increased returns to bidder shareholders).

[175] *See, e.g.*, SKEEL, *supra* note [xx], at xx (describing the effect of options); Kees Cools, *Ebbers Redux*, WALL ST. J. (studying suggesting that the best predictors of the likelihood a company would become involved in a corporate scandal were extent of options based compensation and earnings targets).

C) Summary and Implications

To conclude, it appears from the impressionistic evidence available to us that the UK's system has much to commend it in terms of process. Turning to the rules themselves, whilst the UK's regime certainly seems to be more successful than its counterpart in the US in facilitating takeovers, the simple story of 'more bids good, less bids bad' is not enough to evaluate the respective merits of the two systems.

While these uncertainties remain, a system that tends to facilitate takeovers seems preferable, on balance, to one that permits managers to toss sand in the takeover machinery. Takeovers sometimes misfire, and managers sometimes may have private information about the optimal deployment of the company's assets or the best way to sell a business. But managers' resistance often seems to come more from the self interested desire to protect their position than from superior information.

The divergence in the substantive perspectives reflected in US and UK takeover regulation can be traced, as we have seen, to the two countries' divergent modes of regulation. The emergence of coerced self regulation as the strategy of choice in the UK has produced procedures that further the interests of the institutional shareholders and banks that make the rules. The combination of mandatory federal regulation and judicial enforcement in the US, by contrast, has biased US takeover regulation in a far more manager-friendly direction.

It is important to emphasize once again that the differences aren't quite as stark as they appear on initial inspection. While the judicial approach of the US is much slower than the real time decision making of the City Code, Delaware's courts are extraordinarily efficient by judicial standards, often handing down major takeover rulings almost as soon as the cases are litigated. Similarly, while US target managers have much more protection from unwanted bids than their UK counterparts, companies' use of stock-based compensation has counteracted managers' resistance to takeover bids. At the end of day, however, it remains true that the UK's coerced self-regulation has produced a faster, more shareholder-oriented regulatory framework than the judicially oriented US approach.

It may therefore be tempting to conclude that self regulation is always an optimal regulatory strategy. But this would be a mistake. The effectiveness of self regulation is closely

tied to the incentives of the individuals and entities who are providing the self regulation. If the self regulators' incentives are consistent with social welfare, self regulation can work extremely well– and indeed, in an area characterized by rapid change, may prove far superior to legislative or judicial oversight. If their incentives diverge, on the other hand, self regulation is a much less attractive strategy.

Two examples from the corporate and securities law context will make these intuitions more concrete. The first involves the US stock exchanges, which are treated as self regulatory organizations under the US securities laws. As discussed earlier, until the 1930s, self regulation by the New York Stock Exchange was the principal source of US securities regulation. The brokers and dealers who ran the exchange had an obvious interest in a vibrant securities market, since this strengthened the exchange and maximized their trading opportunities. But their incentives were, at best, imperfectly congruent with the objective of assuring vigorous, efficient corporate governance. Even under the post-New Deal structure, which shifted control from traders and specialists to member-brokers, the NYSE's self regulatory incentives are imperfect.[176] Brokers may have an interest in chilling takeovers if the target is listed on the exchange, even if takeovers are generally efficient, since the takeover may mean one less company listed on the exchange.[177] The NYSE and other exchanges also have a strong interest in keeping important listed firms happy, even if the firm's happiness comes at the expense of effective corporate governance. The NYSE was famously unwilling to stand up to GM, for instance, when GM threatened to bolt if the NYSE tried to prohibit the use of stock with differential voting rights.

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[176] Until it was forced by the New Deal SEC to reform its governance structure, the NYSE "was dominated by floor traders and specialists who traded largely for their own accounts." SELIGMAN, *supra* note [xx], at 166. Since traders and specialists profit from buying and selling stock as part of their responsibility for assuring continuous, liquid trading, they might actually prefer an inadequate level of corporate disclosure; the opacity could enhance the importance of their role and create more opportunities for profitable trading.

[177] Brokers have an even more direct interest in their own fees. The NYSE imposed monopoly, fixed rate pricing on brokers' fee until 1975, when the SEC forced the NYSE to eliminate the requirement, a development known as the "Big Bang." *See, e.g.*, SKEEL, *supra* note [xx], at 169 (describing Big Bang).

Second, recent concerns about the misbehavior of hedge funds have prompted a wide ranging debate about whether reform is necessary, and, if so, what shape the reform should take.[178] One proposal calls for the SEC to pressure the hedge fund industry to devise a set of "best practices" designed "to reduce the incident of fraud through establishing a custom of greater disclosure and transparency to investors."[179] While the threat of more sweeping federal regulation has indeed prompted a newfound interest within the hedge fund industry to provide meaningful information to potential investors,[180] the hedge funds' incentives to self regulate are poorly aligned with the best interests of ordinary investors. Some of the strategies used by hedge funds are beneficial to the market– hedge fund arbitrage improves liquidity and the accuracy of market pricing, for instance– but hedge funds also benefit from strategies (such as the late trading and market timing practices that gave rise to the recent mutual fund scandals) that divert value from other investors. Under these conditions, proposals for self regulation by the industry itself as a substitute for formal regulation need to be viewed with caution.

The incentives of the institutional investors and banks who oversee UK takeover regulation are not perfect, either. Institutional shareholders are, as the name suggests, institutions rather than private individuals. Like the companies they invest in and monitor, the decisions of institutional shareholders are made by agents whose own incentives may be skewed in various ways. They may be affected by political considerations rather than purely economic ones, for instance.[181] But overall, institutional shareholders are likely to focus on the overall

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[178] Despite loud protests from the hedge fund industry, the SEC recently promulgated a rule that will require hedge fund advisors to register with the SEC by February 2006. *See, e.g.,* Gregory Zuckerman, *Hedge Funds Brace for Regulation*, WALL ST. J., June 8, 2005, at C1.

[179] Erik J. Gruepner, *Hedge Funds are Headed Down-maker: A Call for Increased Regulation?*, Comment, 40 SAN DIEGO L. REV. 1555, 1596 (2003).

[180] *See, e.g., id.* At 1595 ("The hedge fund industry has already demonstrated its desire to prove that it does not need increased regulation through distributing best practices recommendations.")

[181] [I assume **STAPLEDON** is the logical **citation** here? We could also cite to Klausner's criticism of institutional shareholder decision making in the IPO context].

The other participants in the City Code process also have imperfect incentives. The London Stock Exchange, for instance, has the same incentive to chill takeovers as just described with the New York Stock Exchange.

profitability of the companies whose shares they hold. A regulatory framework that relies on ongoing regulation by these well-established market players, rather than on mandatory rules and judicial oversight, is likely to exhibit precisely the qualities we have seen in this part: speed, certainty and an emphasis on promoting the interests of shareholders.

VI. <u>THE EC TAKEOVER DIRECTIVE AND THE FUTURE OF THE TAKEOVER PANEL</u>

[To follow]

VII. <u>CONCLUSION</u>

In both the English and American systems of corporate governance, each of which feature dispersed share ownership, the hostile takeover is thought to operate as a disciplinary mechanism for management. Yet both the content of the law governing the resolution of takeover battles, and the way in which it is made and enforced, are quite different in the two systems. Our analysis has explored the causes of this divergence, and its implications for policymakers.

Critics of the US system have compared it unfavourably to the UK's takeover regulation, and accounted for the difference as flowing from the dynamics of competitive federalism. Our public choice account, in contrast, places the mode of regulation at centre-stage in explaining how the differences emerged. Public choice theory implies that legal rules will come to favour the interests of the group(s) with the greatest influence over the rule-making process. In a system of self-regulation, those groups which have the greatest interest in the regulated activity are likely to organise themselves so as to control the rule-making agenda. This fits squarely with UK institutional investors, who between them own nearly 70% of the shares listed on the London Stock Exchange, being the group whose interests dominate the City Code.

Regardless of how well-informed they are about policy issues, judges can only decide cases which come before them. Thus in a system where the law is judge-made, the crucial issue is which group is able to exert the greatest influence over the decision to take cases to trial. The structure of derivative and class action litigation to enforce directors' duties—for example, in a hostile takeover bid situation—tends to be biased towards the interests of directors, leading the content of precedents to tend to be more favourable to their interests. Our claim that the difference in substance flows from the mode of regulation, as opposed to the existence of regulatory competition in the US, is reinforced by the fact that the *common law* of directors' duties in the UK, which is not a federal system, is much closer to the substance of the US model than it is to the City Code.

The question posed by this analysis is why the UK institutional investors were able to 'privatise' their takeover regime through self-regulation, whereas their counterparts in the US were not. The answer to this, we consider, lies in the history of the regulatory fragmentation of financial institutions in the US. This not only made it more difficult for institutional investors to co-ordinate, but it directly preempted certain types of self-regulation by stock exchanges. Had it not been for these legal features of the US landscape, we think it likely that institutional investors would have been able to coordinate similarly to their UK counterparts so as to obviate the need for litigation. Given that both the process and substance of the UK's self-regulatory regime are selected and developed by those who have most at stake in the process, there are strong *prima facie* reasons for thinking it may be superior to that operant in the US.

The implications are twofold. On the one hand, the costs of the federal legislation which restricted institutional investor interaction may be significantly more than have been appreciated. At the same time, there is a certain irony in the fact that prominent critics of US takeover law suggest that the solution is to introduce federal legislation along the lines of the UK's City Code. Federal regulation, responding as it does to populism in the US, is the problem, not the solution, in our view.