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TAKEOVER REGULATION: HISTORICAL AND THEORETICAL PERSPECTIVES ON THE CITY CODE

ANDREW JOHNSTON*

I. INTRODUCTION

THE City Code on Takeovers and Mergers has generally been lauded as a system of self-regulation that offers the advantages of speed, flexibility and low cost administration by experts.[1] Many of its provisions are uncontroversial and do indeed reflect a consensus view about the way in which takeovers should be carried out. However, the Code's prohibition on defensive measures by management in the event of a takeover is far more controversial. This article argues that the City Code – and the prohibition on defensive measures in particular - was introduced because the common law had demonstrated itself incapable of putting in place a system of takeover regulation that ensured the takeover remained a viable means of ensuring managerial accountability to shareholders. Its introduction in 1968 fundamentally transformed the UK's system of corporate governance. Through its prohibition on defensive measures once a takeover becomes imminent, the Code truncates the general management discretion that lies at the heart of company law and forces management to focus on the generation of short-term shareholder value. What is striking is that this fundamental reorientation of the way in which companies are controlled was brought about not by an Act of Parliament but by a self-regulatory measure put in place by financial institutions. Following the implementation of the Takeover Directive, which itself was heavily influenced by the City Code, the Companies Act 2006 now requires the Takeover Panel to maintain that prohibition. Despite this change, it is submitted that the City Code should still be viewed as a self-regulatory instrument which continues to reflect the identity and interests of its drafters.

This article begins with an examination of the emergence of the hostile takeover mechanism. It was the product of the changes in share

* Jesus College, Cambridge

[1] See for example B. Hannigan, *Company Law* (London 2003), p. 874; P. Davies, Gower and Davies' Company Law (7th ed., London 2003), p. 750; G. Morse, "Controlling Takeovers: The Self-Regulation Option in the United Kingdom" (1998) Journal of Business Law 58, 61. On the advantages offered by self-regulation in terms of expertise and cost, see A. Ogus, "Rethinking Self-Regulation" (1995) 15 O.J.L.S. 97, 97–8.

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ownership that occurred in the twentieth century, combined with certain minor changes that were made to company law. Part III then examines the way in which corporate management responded to the development of the hostile takeover, the legal uncertainty surrounding defensive measures and early attempts at self-regulation. Part IV looks at the common law approach to takeover regulation through the application of directors' duties. It is argued that this approach led to a degree of delay and evidential uncertainty that was unacceptable to institutional shareholders in the City, who began to demand a more comprehensive scheme of self-regulation. Part V looks at the emergence and gradual development of the City Code and the effect of the Companies Act 2006 on the way in which takeovers are regulated. Part VI examines two competing theoretical perspectives on takeover regulation and their normative implications, and briefly considers the possibility of reform of takeover regulation.

II. The Emergence of the Hostile Takeover

Before the First World War, companies were generally family-owned and managed. Although this limited the possibilities for expansion and inhibited the professionalisation of management,[2] it did allow companies to avoid the problems associated with the separation of ownership and control. Where families did employ external managers, they found ways of remunerating them in line with performance, either through profit related pay or discretionary bonuses, giving them the correct incentives to maximise profits rather than anything else, such as growth or employment.[3] The situation began to change when the first great wave of mergers hit the UK in the 1920s, and families began to sell out their interests in their companies with the help of promoters, exchanging ownership and control for portfolio diversification.

The 1920s merger wave can be seen as the result of a number of pressures. In the absence of any state regulation of competition, and with overcapacity threatening their businesses, owner-managers favoured mergers rather than cartels, which were inherently unstable, as the best means of restricting competition.[4] The process was

[2] See for example, A.D. Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism* (Harvard 1990), who attributes Britain's weak economic performance to the persistence of "personal capitalism" and its incompatibility with the development of organizational capabilities.

[3] L. Hannah, "Takeover Bids in Britain before 1950: An Exercise in Business 'Pre-History'" (1974) 16 Business History 65, 67.

[4] L. Hannah, *The Rise of the Corporate Economy* (2nd ed., London 1983), chs. 1 and 2. See also B. Cheffins, "Mergers and the Evolution of Patterns of Corporate Ownership and Control: The British Experience" (2004) 46 Business History 256, 265–7. Cheffins notes that many of these merged firms were "loose federations of affiliated semi-autonomous firms rather than tightly integrated business enterprises."

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discussed in terms of "rationalisation", and the fashionable principles of scientific management were used to justify claims that control over the newly enlarged enterprise could be maintained despite considerable increases in size.[5] With the exception of certain key strategic industries, the government's position was neutral: it neither discouraged mergers nor offered finance. In manufacturing in particular, firms either had to finance growth through the retention of profits[6] or else locate finance from private sources. As now, the corporate finance system had an important effect on the prevalence of mergers, with banks often encouraging mergers.[7]

During the 1920s, mergers were largely consensual, being negotiated between the two sets of family owner-managers and aimed at the rationalisation of family-owned enterprises, perhaps as a prelude to listing. The absence of a widespread separation of ownership and control meant that the accountability of managers was not a pressing issue in policy discussions, and hostile takeovers were completely unheard of. Mergers remained consensual even with increasing shareholder dispersal, as, deprived of reliable financial information about the companies in which they had invested,[8] they tended to follow the advice of managers as to the merits or otherwise of the merger. This, coupled with a convention that mergers should be negotiated through the incumbent board, left no scope for hostile bids via a direct approach to the shareholders.[9]

In 1926 the Greene Committee on Company Law recommended the introduction of a right for a bidder who had acquired 90% of the shares to "squeeze-out" any remaining minority shareholders.[10] The reason offered for this recommendation was the risk of "oppression of the majority by a minority", where the minority "either from a desire to exact better terms than their fellow shareholders are content to accept or from lack of real interest in the matter" held up "an arrangement which commends itself to the vast majority of their fellow shareholders".[11] The Greene Report was strongly influenced by the

[5] Hannah, above note 4, ch. 3

[6] This was certainly possible, as Morris demonstrated: see Hannah, above note 4, at 55

[7] However, the transaction costs of raising finance from the public through the stock exchange meant that mergers of a number of small firms generally *preceded* listing, so as to enable the newly merged company to take advantage of economies of scale in financing: see generally Hannah, above note 4, ch. 2. While the issue of shares for the purpose of acquisitions led to the dilution of family control through shareholdings, many families continued to hold seats on boards: See J. Franks, C. Mayer and S. Rossi, "Spending Less Time with the Family: The Decline of Family Ownership in the UK" (2004) European Corporate Governance Institute Working Paper No 35/2004 at 3

[8] Hannah above note 4, at 130.

[9] Hannah above note 3, at 66–69.

[10] See *Report of the Company Law Amendment Committee* (1925–26 Cmd 2657), Part O Reconstruction and Amalgamation, paragraphs 84–5

[11] Hannah (above note 3) notes at p.68 that "the history of [shareholders'] attempts to thwart the decisions of directors and achieve a better bid price is largely a study in failure." An inability to

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prevailing enthusiasm for "rationalisation" and economies of scale.[12] It emphasised – correctly at the time - that takeovers were merely a secondary route to amalgamations and rationalisation in circumstances where an asset sale would be inappropriate, rather than as a spur to managerial efficiency.[13]

Following this recommendation, section 155 of the Companies Act 1929 introduced a right for the purchaser whose offer had been accepted by a 90% majority to force the remaining 10% of shareholders to sell their shares on the same terms, with a right of appeal to the court on questions of value and oppression.[14] Despite the controversial nature of statutory provisions that allow the compulsory purchase of property, they seem to have provoked little debate,[15] and the proposal received no substantial discussion in Parliament. Although it was not their aim, these provisions later proved absolutely fundamental to the emergence of the hostile takeover in the 1950s. It allowed a takeover bidder to acquire the

achieve a better price would not, however, preclude shareholders who were unwilling to sell from remaining as vulnerable – in the absence of adequate minority protection laws - but irritating minority shareholders.

[12] The section was used in the formation of ICI in the 1920s merger wave: see *In Re Castner-Kellner Alkali Company Ltd* [1930] 2 Ch. 349.

[13] The Greene Report (above note 10) identified two situations in which it would be "necessary that the concern which is in substance being taken over should be kept alive and the amalgamation should be carried through by a transfer of shares and not by a sale of assets," namely where it was sought to preserve "the goodwill associated with the name of the company taken over" and where "part of its property (e.g., a licence to use a patent assignable only with a consent which cannot be obtained) cannot be assigned." As we will see below, the argument that takeovers have a key role to play in constraining management discretion was raised for the first time by Marris in 1964 (below note 22), and the market for corporate control was first discussed in formal terms by Manne in 1965 (below note 124).

[14] s.155 Companies Act 1929 subsequently became s.210 Companies Act 1948, then s.429 Companies Act 1985 and is now to be found in ss.979 et seq. Companies Act 2006. The Financial Services Act 1986 belatedly added the counterpart to this right to "squeeze out": a right of minority shareholders to be bought out. Section 172 and Schedule 12 Financial Services Act 1986 added ss.430A–C Companies Act 1985, which allows a minority shareholder who did not accept a bid to require a purchaser who has purchased over 90% of the shares to buy his shares. This would prevent coercive bids – although the possibility of these is greatly restricted by the City Code which requires equal treatment and information of shareholders – and also, more importantly, protects the small shareholder who was not paying attention when the takeover bid was made. The rules about "sell out" can now be found in ss.983 et seq. of the Companies Act 2006.

[15] In *Re Hoare & Co* [1933] All E.R. 105, Maugham J. said that he was unable to understand why the legislature should ever have passed section 155 at all. In *Re Evertite Locknuts* [1945] Ch. 220, Vaisey J. said the section was of a "somewhat curious character". Wedderburn (1960) 23 M.L.R. 663, writing before the introduction of the City Code, notes its role in preventing "oppression" of the majority by the minority, and questions the assumption that a takeover would not go ahead in the face of a recalcitrant minority, but also suggests that it promotes general offers to the shareholders rather than more secretive ones. He questions whether the court is best placed to assess fairness, and calls for a more active administrative agency for "the future control of companies and their management." These powers of compulsory acquisition appear to have influenced Brightman J.'s decision in *Gething* v. *Kilner* [1972] 1 All E.R. 1166 to impose a duty on the directors "to be honest and not to mislead" in offering advice on the merits of the bid; he observed that "a shareholder in the offeree company may be prejudiced if his co-shareholders are misled into accepting the offer… because as soon as the appropriate percentage of shareholders have been misled and assented, the minority become subject under s209 of the Companies Act 1948 to statutory powers of compulsory purchase."

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entire share capital of its target, thereby preventing minority shareholders from free-riding on its efforts to improve efficiency. In the absence of "squeeze out" rules, the incentives of bidders to monitor managerial performance and launch takeovers would have been seriously limited.[16]

While there is an ongoing dispute about the extent to which the 1920s merger wave resulted in the transformation of the corporate economy from family-controlled businesses into modern large corporations in which ownership and control had separated, it seems clear that the process had advanced considerably by the end of the 1950s, and was largely complete by the end of the 1960s.[17] During the 1960s, a second great merger wave hit the UK, resulting in further significant changes. Ownership and control continued to separate and led to the emergence of a professional class of managers who were not necessarily shareholders in the business.[18] Furthermore, as families continued to divest themselves of the shares they held in merged companies, the purchasers were increasingly institutional investors who had gained an appetite for company securities in the 1950s,[19] and by the end of that decade were beginning to dominate the shareholder registers of the largest companies.[20]

These changes in share ownership had profound corporate governance implications. Firms were freed from the financial constraints of family ownership, and key finance decisions were in the hands of professional managers. As had been identified by Berle and Means in the United States in 1932,[21] a system of managerial capitalism was beginning to emerge in the UK, of which the essence, according to Marris, was the freedom of management to retain corporate income and to use it to expand the business.[22] Increasingly, companies retained their earnings: this reduced the company's cost of capital, as there were no transaction costs, but restricted the role of the capital markets in allocating capital to the most profitable business opportunities. In those companies without a dominant shareholder, dispersed shareholders had little choice but to give management a free

[16] G. K. Yarrow, "Shareholder Protection, Compulsory Acquisition and the Efficiency of the Takeover Process" (1985) 34 Journal of Industrial Economics 3, 3–4.
[17] See Cheffins (above note 4, at 259–262), who argues that, despite Hannah's claims to the contrary, the weight of evidence is that "personal capitalism" was not displaced by the 1920s merger wave. Instead it began to be gradually unwound during the first of half of the twentieth century, and the process accelerated after 1950, with the transition to big business largely complete by the end of the 1960s merger wave.
[18] See Hannah, above note 4, ch. 10
[19] See Cheffins (above note 4, at 268) who notes that a "'cult of the equity' became entrenched in the UK for the first time in the 1950s."
[20] Franks, Mayer and Rossi (above note 7), at 4–5
[21] A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (New York 1932).
[22] R. Marris, *The Economic Theory of Managerial Capitalism* (London 1964), at 13.

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hand in this regard, given the insurmountable collective action problems they faced.[23]

Accordingly, when the hostile takeover emerged in 1953, institutional investors like pension funds, whose shareholdings were constantly increasing during this period and for whom financial considerations were paramount, were happy to sell out at a premium to the market price.[24] The emergence of the hostile takeover at this time can be explained by reference to a number of factors. The Companies Act 1948 had, for the first time, required that companies should make public data on their current earnings, and this, coupled with more stringent accounting standards, enabled predators to investigate targets far more easily.[25] Roberts notes that direct approaches to shareholders were impossible prior to 1953 because of paper rationing.[26] Bull and Vice, writing in 1958, offered a number of further explanations. First, British industry was undergoing structural change, with a shift in production from textiles and heavy capital goods to aircraft, light electrical engineering and machine tools. Consumption was on the rise with more equal income distribution and changes to retailing. These factors made the differences between efficient and inefficient firms more obvious.[27] Second, there was a sharp rise in the tax burden, which took a far larger share of corporate profits, so directors reduced the amount distributed to shareholders from 52 percent of gross trading profits in 1938 to 20 percent in 1952, in order to ensure sufficient funds for growth.[28] Other commentators emphasised the Government policy between 1949 and 1951 of encouraging dividend restraint.[29] Furthermore, companies tended to hoard surplus cash to fund replacement of assets in an era of high inflation. The low level of distribution to shareholders that resulted from these constraints meant that the share price failed to keep pace with the growth of companies' profit-earning assets. To make matters

[23] See further B. Cheffins, "Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom" (2006) European Corporate Governance Institute Law Working Paper No. 69/2006 at 13. Cheffins notes (at 14), "By the beginning of the 1950s, family control of some form remained the norm in major U.K. companies. Nevertheless, among the very largest firms, a trend towards a divorce between control and ownership was becoming clear." We should also note that shareholders were not necessarily opposed to income retention as the tax treatment of capital gains was more favourable than income distributions because of the absence until 1965 of capital gains tax.

[24] The first hostile takeover is generally considered to be Charles Clore's bid for J. Sears & Co.: see R. Roberts, "Regulatory Responses to the Rise of the Market for Corporate Control in Britain in the 1950s" (1992) 34 Business History 183, 185–7; Cheffins (above note 4), at 272.

[25] See G. Bull and A. Vice, *Bid for Power* (3rd ed., London 1961); R. Cranston, "The Rise and Rise of the Hostile Takeover", in K. Hopt and E. Wymeersch (eds.), *European Takeovers: Law and Practice* (London 1992), at 79; Cheffins (above note 4), at 270; Roberts (above note 24), at 184; Hannah (above note 3), at 75; Hannah (above note 4), at 149.

[26] Roberts (above note 24), at 186.

[27] Bull and Vice (above note 25), at 29.

[28] *Ibid.*, at 30.

[29] See R.W. Moon, *Business Mergers and Takeover Bids* (3rd ed., London 1968) at 124–5.

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worse, many key corporate assets, especially property, were undervalued on balanced sheets, having not been revalued since before the war, and were increasing in value rapidly during this period.[30]

This combination of factors presented bidders with an opportunity that was too good to pass up. Shares were very cheap compared to the assets that companies had under their control, and if a bidder could gain control of the company and liquidate that surplus value, he could realise large profits. The hostile takeover was the mechanism through which bidders pursued such strategies. Having acquired control of the general meeting, the bidder replaced incumbent conservative management with someone who would maximise the returns generated by the company's assets – frequently by selling freehold properties to insurance companies and leasing them back - and distribute the surplus cash that was being held within the business.[31]

III. Managerial Responses to the Hostile Takeover and the Move to Regulation

The sudden emergence of the hostile takeover posed a threat to the livelihood of corporate managers and triggered a "boardroom revolution" between 1952 and 1955. Company directors reversed their policy of retaining earnings to fund growth and increased dividend payouts to shareholders, which had the effect of raising share prices but stripping companies of their accumulated reserves for future capital investment.[32] Other courses of action commonly taken included declaring a scrip issue (bonus shares), returning surplus cash to the shareholders and pre-empting the actions that a successful bidder would be likely to take, such as selling valuable assets to insurance companies and leasing them back, or introducing new personnel onto the board. In any event, while the tactic of raising share prices may have contributed – along with the increased profitability of businesses generally - to a stock market boom between 1952 and 1955, it ultimately had little effect in terms of protecting management from removal from office, with most shareholders preferring a tax-free capital gain to taxable dividend income, and so happy to sell out at a premium to the market price.[33] As Bull and Vice commented, "takeover bids were unavoidable unless some form of taxation on capital gains had been imposed."[34]

The failure of this approach drove management to increasingly desperate – and complex - schemes to fend off unwanted bids. The

[30] *Ibid.*, at 125. See also Cranston (above note 25,) at 79.
[31] Bull and Vice (above note 25), at 31–2.
[32] *Ibid.*, at 11; Moon (above note 29), at 126.
[33] Bull and Vice (above note 25), at 32.
[34] *Ibid.*, at 37. See also Moon (above note 29), at 125.

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classic example is the Savoy Hotel affair. Fearing that a hostile takeover was to be launched with the aim of converting the Berkeley Hotel into offices, which would be more profitable than its existing use as a hotel, the board of Savoy Hotel Ltd. drew up a scheme to put the Berkeley Hotel beyond the control of shareholders, thereby preventing any bidder from changing its use.[35] The complex scheme essentially involved transferring the property to the "Worcester Company" at full market value in return for preference shares in Worcester that gave Savoy Hotel Ltd the right to all income and capital after the payment of certain preferential dividends. They also created a staff benevolent fund which subscribed for ordinary shares in the Worcester Company that were subsequently vested in trustees of the fund who could not be removed by the company. The Berkeley was then leased back to Savoy Hotel Ltd with covenants that it would not be used other than as a hotel without the consent of the trustees of the Worcester Company, removing any way for the speculator to profit by taking control of these assets and selling them with a lease back.

For various reasons, the matter never came before the court, but the Board of Trade, at the request of one of the bidders, appointed an inspector, Mr Milner Holland QC, under s.165 Companies Act 1948, to investigate whether the board of the Savoy Hotel had committed any breach of fiduciary duty to the company or its members by carrying out the Worcester Scheme. He found as a fact that "the object of the Worcester Scheme was to deny any person who might obtain majority voting control of Savoy Hotel Ltd the power to bring about a sale or change of user of the Berkeley Hotel and thereby to discourage those who were seeking control from further pursuing their objective." He also found that the directors "genuinely considered that, on a long term view, it was for the benefit of the stockholders that the existing user should continue unchanged." It is notable that counsel had advised the board that this course of action was open to them, and that "the interests of the company" meant the interests of present and future members and that they could balance a long-term view against the short-term interests of present members.[36]

Holland concluded that good faith alone would not suffice to exonerate the directors from breach of duty. He argued that it was essential to examine the object underlying the exercise of management power. Here, he found as fact that their object was "to render irrevocable for all time the policy view of the present Board" and to make it impossible for the shareholders to "alter the decision of their present Board as to the present or future use of the property of the

[35] For a detailed summary see L.C.B. Gower, "Corporate Control: The Battle for the Berkeley" (1955) 68 Harvard Law Review 1176.
[36] For further details, see *ibid.* at 1184–5.

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Company."[37] He concluded that the action was invalid, although he admitted that he could find no legal authority for his view.[38]

In his well-known comment on the case, Gower rationalised Holland's conclusion on the basis that the shareholders of Savoy Hotel Ltd may have retained their rights to the fruits of the property but they "had lost, without any compensation, their right to control its future. In effect the directors had given away some of the company's property without compensation."[39] The shareholders continued to receive all income and capital gains through their ownership of the first preference shares, which represented the full market value of the transfer of the building, as well as a six *per cent* preferential dividend. A six *per cent* preferential dividend also went to the employee beneficial fund; this clearly fell within the scope of managerial discretion. What the shareholders lost, according to Gower's ingenious argument, which draws on US authorities that restrict the ability of the board to limit the discretion of its successors, was their indirect right to determine the ownership and future use of the hotel through their right to hire and fire the board.

Everything turned on Milner Holland's conclusion of fact that the object of the scheme was to prevent future disposals of the premises. His ultimate finding that the directors' action was illegal can certainly be questioned. It can be argued that English company law gives the directors discretion to set a time frame for producing a return for the shareholders, and to make any contracts that they consider appropriate for their business strategy. A firm commitment to running the Berkeley as a hotel could be justified on this basis. Gower's argument too is problematic: the shareholders' right to dispose of the hotel would equally have been used up on a sale at market value – and the shareholders would have received nothing for it separate from the sale consideration. Whenever directors of a company sell that company's property, the shareholders indirectly lose their right to influence future dispositions of that property by changing the board. If the directors had decided to sell the company's business, something which was clearly within their management powers, or to sell its property and lease it back – as was common at the time, and as any takeover bidder would have been likely to do – this would also have bound subsequent

[37] Holland also stated that he would have rejected an argument from the directors that they were acting in the interests of employees, customers and the public as "considerations which, however meritorious, would not seem to me to form part of a true legal definition of the interests of the companies, except that indirectly a substantial reduction of staff might have unsettled the staff remaining at the other hotels and restaurants." Holland's shareholder-centric conception of the "interests of the company" is clear.

[38] Holland noted the "apparent absence of any judicial decision which bears directly upon them; and it need be a matter for little surprise that different minds reach different legal conclusions in answering them."

[39] Gower (above note 35), at 1186.

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boards, yet would surely have been unobjectionable. The board's actions were in fact only objectionable from a short-term shareholder perspective, especially when compared with the alternative, which was to sell the property to a cash-rich buyer such as an insurance company and then lease it back, allowing the cash proceeds to be distributed to the shareholders.

Regardless of the view one takes of the correctness of Holland's conclusion and the persuasiveness of Gower's justification of it, the Savoy Hotel affair – and the conflicting views expressed on its legality - demonstrates the extent of the legal uncertainty surrounding the ability of management to take action which undermined the viability of takeover bids. It also highlights the vulnerability, in the absence of regulation, of passive shareholders in large public companies to defensive actions taken by the directors. This type of scheme was not an uncommon response on the part of company directors to the emergence of the hostile takeover bid.[40] The Savoy Hotel affair made it abundantly clear that regulation would be vital to ensuring that the hostile takeover mechanism would continue to operate.

The hostile takeover bids that were launched in 1953 were a sign of things to come. However, Government opposition to the technique meant that it disappeared for a few years.[41] While legislation prohibiting hostile takeovers was "ruled out for practical and ideological reasons",[42] the Bank of England exercised its informal control over conduct in the City by repeating its warning to banks and insurance companies (both domestic and foreign) not to lend money for speculative purposes, including takeover bids.[43] This had the effect of cutting off the credit supply to bidders, and they were prevented from offering shares by the capital issue consent requirements and a bearish stock market.[44]

In the late 1950s, Government policy changed once more and between 1959 and 1961 the hostile takeover re-emerged. Roberts explains that the relaxation of lending restrictions in 1958 made finance easier to obtain,[45] paving the way for cash bids, and the abolition of consent for capital issues in 1959 facilitated paper bids. Furthermore, the "financial establishment's" attitude to hostile bids was changing, in particular as a result of the Government's encouragement of a hostile bid for British Aluminium. However,

[40] See for example Moon (above note 29), at 132–3 for a discussion of the Atholl transaction, which was similar to the Worcester scheme and was put in place by SMT in response to competing bids from Clore and Fraser. While an interlocutory injunction was obtained on the basis of a prima facie case, no full hearing of the merits occurred and the legal position remained uncertain.

[41] Roberts (above note 24), at 187–9.

[42] Roberts (above note 24), at 189.

[43] Roberts (above note 24), at 188–190.

[44] Roberts (above note 24), at 191.

[45] Roberts (above note 24), at 191 and 197.

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management were increasingly using their powers to hinder the progress of bids of which they did not approve, and for the first time, regulation of takeovers was being openly discussed.

1959 saw two significant events for the regulation of takeovers. First, the Governor of the Bank of England convened a conference to consider the production of a Code of Conduct to regulate takeover bids, which proceeded on the basis that, if correctly regulated, takeovers were beneficial to the economy.[46] On 31st October 1959, at the instance of the Bank of England, the "Notes on Amalgamations" were published by the Issuing Houses Association in conjunction with a number of other City institutions.[47] This was the first attempt at self-regulation, and in many ways shaped the form of the City Code. Secondly, the Jenkins Committee was appointed in November 1959 following Labour Party demands for a statutory body to regulate takeovers and continuing criticism of Government policy.[48] While many of the recommendations of the Jenkins Committee as regards takeovers were not implemented in legislation, it nevertheless also had a significant influence over the way in which takeovers are regulated today.

The Notes endorsed the virtues of amalgamations, and stated that these processes "should continue and should not be artificially impeded." Divided between principles and procedure – a distinction which persists in the Code today – they insisted that there should be "no interference with the free market in shares and securities of companies", that shareholders should decide whether to sell their shares, and that, in order for that decision to be based on adequate information, "it is the duty of the Board of [the target] company to make every effort to ensure that such information is provided and to give [shareholders] their advice." In terms of procedure, the Notes insisted that offers should generally be for the whole of the company's share capital, with partial offers being considered exceptional, and even then should be made to all shareholders pro rata. They also suggested that offers should remain open for three weeks, and, as the Jenkins Report subsequently noted, required the bidder to

[46] The conference was attended by representatives of the Bank of England and of the Stock Exchange, the Committee of London Clearing Banks, the British Insurance Association, the Association of Investment Trusts, the Accepting Houses Committee and the Issuing Houses Association: see Roberts (above note 24), at 194–5

[47] On this, see generally A. Johnston, *The City Takeover Code* (Oxford 1980), ch.3. The Issuing Houses Association, which was "a body intended to represent the interests of issuing houses to the regulatory authorities" was formed in 1945 by the Accepting Houses Committee as merchant banks moved into the underwriting of new share issues. Its membership was stable at between 50 and 55 houses: see D. Chambers, "Gentlemanly Capitalism Revisited: A Case Study of the Underpricing of Initial Public Offerings on the London Stock Exchange 1946–1986" (2005) University of Oxford Department of Economics Working Paper No 253, at 4, 7.

[48] Roberts (above note 24), at 194; Johnston (above note 47), at 22.

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make a statement of his intention as regards the company and its employees.[49]

The obligation on the board to provide information to shareholders was a considerable change from the common law position, which did not require the board to provide information to assist shareholders to make informed decisions. In *Re Evertite Locknuts*,[50] the court was presented with the opportunity to consider the information provided to shareholders as part of its assessment, under s155 CA 1929, of whether an offer was fair. The applicant alleged that an offer was unfair because the directors had supplied insufficient information for him to ascertain whether the offer was a fair one. Vaisey J. agreed that the applicant had received "meagre" information, but was afraid that if the scheme could be upset on the basis of inadequate information there would be "no limit to the inquiry which would have to be set on foot as to the extent to which his demands for disclosure ought to be conceded."[51] Accordingly, he held that the applicant had to demonstrate that the offer was unfair, not merely that insufficient information had been given to him. In this context, and coupled with the reforms to company accounting that were introduced in the Companies Act 1948,[52] the Notes were an important innovation in facilitating informed decision-making by shareholders.[53]

The Jenkins Committee was given a limited mandate: they were to consider the duties of directors and the rights of shareholders in the event of a bid, but broader questions of social and economic policy were excluded.[54] It is also significant that the City had already – if somewhat hastily – put in place self-regulation in the form of the Notes.[55] While the Committee viewed "take-overs, mergers and amalgamations of companies… [as] an essential feature of economic

[49] See Report of the Company Law Committee, Cmnd. 1749 J.une 1962, paragraph 267.

[50] Above note 15.

[51] *Ibid.*, at 224.

[52] See sources cited at note 25 above.

[53] Further regulation of information disclosure was introduced by the Licensed Dealers (Conduct of Business) Rules 1960 (S.I. 1960/1216), which were produced by the Board of Trade and came into force in August 1960. They regulated the form of takeover offers circulated by licensed dealers in securities. For anyone other than a licensed dealer to make a public offer, the consent of the Board of Trade was required under s14 Prevention of Fraud (Investments) Act 1958, and they invariably made it a condition that the offer should comply with the Rules. The Licensed Dealers Rules required disclosure of information about recent movements in the stock price, a statement of the duration of the offer, which had to be at least 21 days, the form the consideration would take, and various other matters. See further R. Pennington, "Takeover Bids in the United Kingdom" (1969) 17 American Journal of Comparative Law 159, 161–2.

[54] Jenkins Report, above note 49, paragraphs 16 and 265. The Jenkins report is available online at http://www.takeovers.gov.au/display.asp?ContentID=543 (checked 30th March 2007). The Jenkins Committee's evaluation of the Notes is to be found in paragraphs 265–294.

[55] Bull and Vice (above note 25), at 16 suggest alternative explanations for the production of the notes: the controversy caused by the Watney Mann affair and fears that heavy-handed government action against takeover bids was imminent.

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growth and development'',[56] they felt compelled to address a number of continuing abuses in the conduct of takeovers.

First, in a number of cases, including the Savoy Hotel affair discussed above, company directors had used their management powers to divert the company's assets to uses to which the shareholders would have objected.[57] These schemes had been widely condemned in much of the media. Despite protests from company directors during the British Aluminium takeover that a requirement of shareholder consent for significant disposals would be impracticable,[58] the Committee recommended exactly that. They proposed a mandatory statutory provision requiring shareholder approval where the board proposes disposing of the whole or substantially the whole of the business or assets of the company.[59] This recommendation certainly fits with the Jenkins Committee's operating assumption that takeovers should not be discouraged, but ultimately did not become law, probably because it would have imposed a heavy burden on corporate management that reached far beyond the takeover situation. Furthermore, it only addressed one particular type of defensive measure, so could have been easily circumvented. However, it was considerably less restrictive of managerial discretion than the solution eventually introduced by the City Code (see below).

Second, the Committee considered whether voteless shares, the use of which as consideration in takeover bids had caused widespread concern, should be prohibited. They allowed the bidder to retain control of the merged enterprise while expanding the business. The majority of the Committee felt that prohibition would be too ''drastic'', and that the matter could be more effectively dealt with by ensuring – through co-operation with the stock exchange and the press - that there was sufficient publicity to ensure that the public was not being misled into accepting them. This seems to have worked, and

[56] Jenkins Report, above note 49, paragraph 265.
[57] Jenkins Report, above note 49, paragraph 111.
[58] See Bull and Vice (above note 25), at 55, discussing the British Aluminium takeover.
[59] See generally Jenkins Report, above note 49, paragraphs 119–122. The proposal restricting disposals of course did not become law, but the Stock Exchange's Memorandum on Acquisitions already required publicity for substantial acquisitions and disposals amounting to 15% or more of the company's assets: see Pennington (above note 53) at 167–8. Now see Rule 10 of the Listing Rules, which is designed to ensure that shareholders are informed about – and in the most serious cases, consent to - transactions that are outside the ordinary course of a listed company's business and might affect shareholder interests. A variety of ''class tests'' are set out in the Annex to Rule 10. Essentially, the value of the proposed transaction is compared to the value of company as a whole (by reference to gross assets, profits, consideration and gross capital). Transactions are then divided into three classes. Where all of the tests yield a ratio over 25%, the proposed transaction is in Class 1, meaning that the contract must be made conditional on shareholder approval, which must be obtained following circulation of a detailed explanatory circular. Smaller transactions falling within Class 2 dispense with the requirement of consent but still require explanation, while those in Class 3 only require outline information to be provided to shareholders. The class test operates principally to protect shareholders in bidder companies from ''empire-building'' by directors whose company has a high share price.

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in any event – in a demonstration of their growing market power - institutional investors were already refusing to buy these shares, and by 1963 they were little used in the takeover context.[60]

As for other aspects of takeovers, the Committee found that the existing regulations already dealt with most other matters. They rejected the suggestion that bids should be required to include a cash option, and recommended that shareholders should be provided with adequate information to enable them to assess the merits of the offer, something that the Notes already required.[61] They expressed their approval of the recommendation contained in the 1959 Notes that the bidder should state their intentions with regard to the business and its employees, and rejected an argument that this should be required by statute. They also expressed the view that company law was not the appropriate place to deal with the problems posed by takeovers for employees.[62] Finally, the Report approved many of the rules contained in the Licensed Dealers (Conduct of Business) Rules 1960, which regulated the conduct of takeovers, as a "most effective and useful guide to the proper conduct of take-over offers."[63]

Despite the Committee's general approval of the existing regulatory scheme, its most important recommendation was probably that the Board of Trade should be given a power to introduce further regulations of the conduct of takeovers by statutory instrument.[64] There is no doubt that this gave impetus to the Revised Notes, which were issued in 1963 and ultimately to the production of the City Code itself in 1968.

1963 saw a further revision of the Notes. The requirement that any revised offer should be extended to those shareholders who had already accepted an earlier, lower offer is particularly noteworthy. However, as little more than a code of conduct,[65] the Revised Notes were increasingly flouted,[66] given the high level of activity in mergers and acquisitions between 1961 and 1968.[67] 1967 in particular saw a series of bitterly contested bids, with the abuses identified by Jenkins once more to the fore. Directors continued to issue shares to their

[60] On the reluctance of institutional investors to purchase voteless shares see Franks, Mayer and Rossi (above note 7), at 5.

[61] Jenkins Report, above note 49, paragraph 264.

[62] Jenkins Report, above note 49, paragraph 267. They noted that "While we are very much aware that the livelihood of employees and directors may be affected by a take-over bid, the problems of redundancy and contractual rights which may arise following a take-over are clearly matters which may arise in many other circumstances, and cannot appropriately be dealt with by amendments of company law."

[63] *Ibid.*, paragraph 274.

[64] *Ibid.*, paragraph 272.

[65] S. Deakin, *Renewing Labour Market Institutions* (Geneva 2004), at 26.

[66] See D.D. Prentice, "Takeover Bids – The City Code on Take-Over and Mergers" (1972) 18 McGill Law Journal 385, 387.

[67] See Johnston (above note 47), at 30.

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preferred bidders,[68] and the problem of market purchases during the bid, whether by bidders or interested third parties, continued to grow.[69]

IV. Takeover Regulation at Common Law

With suitable targets growing scarcer, and numbers of bidders growing, bids were increasingly contested. With different methods of takeover regulation under consideration, but nothing other than the Notes forthcoming, litigation over defensive measures taken by boards of directors was coming before the courts with increasing frequency. The courts sought to resolve these disputes through an application of pre-existing directors' duties. The general approach taken by the common law to corporate decision-making had been to allow management wide discretion; the limits to the business judgement rule were established by the requirement that decisions be motivated by proper purposes. Through the courts' application of the proper purpose rule, managerial decisions that could be construed as defensive measures in response to takeovers were regulated no differently from any other managerial decisions. The court would conduct a detailed examination of the factual context in which a decision was taken in order to ascertain the purposes behind it. In this way legitimate management decisions could be distinguished from illegitimate ones. While this approach was entirely compatible with the existing managerialist system of company law, it was less than satisfactory from the perspective of investors because it caused considerable uncertainty and delay, and so made takeovers less likely to succeed. Indeed, there was a danger that litigation itself could become a potent defensive measure.

The two leading examples of the common law approach to defensive measures illustrate this point.

A. Hogg v. Cramphorn Ltd.[70]

Along with locking up key assets, which had been heavily criticised in Milner Holland's report, the other defensive tactic used by boards faced with unwanted takeover bids was to allot unissued shares to a friendly recipient. In this case, the board of Cramphorn Ltd., a public but unquoted company, received an unwelcome takeover bid from Baxter. In response, the directors created a trust for the benefit of the

[68] For example, Metal Industries issued shares to Thorn when faced with an unwelcome takeover bid from Aberdare, despite an apparent undertaking by the directors to the general meeting not to issue them if it would result in a change of control when they were created in 1960: see Bull and Vice (above note 25), at 35 and Moon (above note 29), at 135.

[69] See the example of the bid of Philips for Pye given by Moon (above note 29) at p.136.

[70] [1967] Ch. 254, [1966] 3 All E.R. 420.

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company's employees to which they allotted a number of shares, each of which carried the right to exercise ten votes on a poll vote. The trustees were to be nominated by the directors, and their indirect control over the additional votes attached to these shares ensured that the directors retained control of the company.

The parties agreed – correctly[71] - that establishing a trust for the employees was not *per se* an improper use of the board's management powers and it was also "common ground that the scheme of which this allotment formed part was formulated to meet the threat, as the directors regarded it, of Mr Baxter's offer. The trust deed would not have come into existence, nor would the 5,707 shares have been issued as they were, but for Mr Baxter's bid and the threat that it constituted to the established management of the company." Accordingly it was clear on the facts that "an essential element of the scheme, and indeed its primary purpose, was to ensure control of the company by the directors…"[72] and prevent the takeover. It was also clear that the directors had acted in good faith throughout and honestly thought that their keeping control was in the company's best interests, in the sense that giving "the staff through the trustees a sizeable, though indirect, voice in the affairs of the company would benefit both the staff and the company."[73]

This decision would clearly satisfy the business judgement rule: the directors had acted in good faith in what they considered to be the company's interest by treating the employees in an enlightened manner. However, on these facts, the board had acted primarily for an improper purpose, namely maintaining their control of the company. Buckley J. referred to a long-standing line of cases which established that directors breach their fiduciary duty where they issue shares "merely for the purpose of maintaining their control or the control of themselves and their friends over the affairs of the company, or merely for the purpose of defeating the wishes of the existing majority of shareholders."[74] Where such an improper motive was

[71] This type of action falls within their general power of management and is allowed under the *Hutton* v. *West Cork Railway* ([1883] 23 Ch. 654) principle of "cakes and ale… for the benefit of the company". The shares were funded by an interest-free loan out of the company's reserves, which although described as "Employees' Benevolent and Pension Fund" was the "absolute property" of the company. It would also be permitted under s309 of the Companies Act 1985, which required the board to "have regard in the performance of their functions [to] the interests of the company's employees in general". It seems incontestable that it would also be allowed under s172 of the Companies Act 2006, which requires the directors to take account of the interests of the employees in discharging their good faith duty to promote the success of the company for the benefit of its members as a whole.

[72] [1967] Ch. 254, at 266–7.

[73] [1967] Ch. 254, at 265.

[74] *Per* Peterson J., in *Piercy* v. *Mills* [1920] 1 Ch. 77 at 85. Precedent stretched back as far as the 1864 decision in *Fraser* v. *Whalley* 2 H & M 10, where (at 29) the evidence showed that the directors had "on the faith of this obsolete power entrusted to them for a different purpose…issued [shares] for the very purpose of controlling the ensuing general meeting."

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apparent from the evidence, the court would intervene because it would not "permit directors to exercise [fiduciary] powers…in such a way as to interfere with the exercise by the majority of its constitutional rights."[75]

This line of authority establishes that the court does not look beyond primary purpose. The validity of the decision turns on the facts that the court finds about the board's *primary or sole purpose*. If that purpose is not to maintain control in the face of an unwelcome takeover bid, but rather is part of their normal management of the affairs of the company, their actions will not be caught by this precedent and will not constitute a breach of their fiduciary duty. There would arguably have been no breach of duty in *Hogg* if the board had acted to benefit "the company" by treating its employees well, as long as their *primary purpose* was not to ensure that they retained control. Indeed, Buckley J. confirmed that the fiduciary power to issue shares is not granted to the board for the sole purpose of allowing them to raise capital.[76] Thus the ratio of *Hogg* is very narrow. *Hogg* only applies where, *as a matter of fact*, the board, aware of a bid, uses its fiduciary powers *for the primary purpose* of manipulating the voting position and frustrating that bid. Accordingly, the motive or purpose for which the fiduciary power is exercised is absolutely crucial to establishing whether there has been a breach of duty, and will be a matter for the court to assess in each case.[77]

B. *Howard Smith Ltd. v. Ampol Petroleum Ltd.*[78]

In this case, the board, faced with two competing bidders, issued shares to their preferred bidder, reducing the previous controlling shareholding to a minority interest and allowing an effective takeover

Similarly in *Punt* v. *Symons & Co Ltd* [1903] 2 Ch. 506, the court found at p.517 that the board had improperly used its fiduciary power to issue shares "for the express purpose of acquiring an unfair majority for the purpose of altering the rights of parties under the articles."

[75] [1967] Ch. 254. at 268,

[76] Based on *Punt* v. *Symons & Co Ltd* [1903] 2 Ch. 506 at 516 ("There may be occasions when the directors may fairly and properly issue shares in the case of a company constituted like the present for other reasons"); also *Piercy* v. *S. Mills & Co Ltd* [1920] 1 Ch. 77. Lord Wilberforce confirmed this in *Howard Smith Ltd* v. *Ampol Petroleum Ltd* [1974] A.C. 821, at 835–8.

[77] In each of the cases in this line of authority, the evidence before the court was unequivocal that the shares were issued for the "very" purpose (*Fraser* at 29), the "express" purpose (*Punt* at 517) or "solely" for the purpose (*Piercy* at 83). This narrow interpretation was confirmed by Megarry J. in *Gaiman and others* v. *National Association for Mental Health* [1970] 2 All ER 362, at 374. He stated that the "issue of shares with the object…of affecting the balance of voting power, is thus an exercise of powers made with a purpose that is ulterior". Once it was clear that "it was an exercise of a fiduciary power with an improper motive… it was immaterial that the directors believed in good faith that the issue was in the interests of the company." See also the emphasis placed on the board's motive in *Bamford* v. *Bamford* [1969] 1 All E.R. 969 and *Lee Panavision Ltd* v. *Lee Lighting Ltd* [1992] B.C.L.C. 22.

[78] [1974] A.C. 821, P.C., [1974] 1 All E.R. 1126, a case on appeal to the Privy Council from the Supreme Court of New South Wales

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offer to be made by their preferred bidder. This was held to be an improper use of their fiduciary powers. As in *Hogg*, the propriety of the board's exercise of their powers was determined by a factual inquiry into their motivation. At first instance the board had argued that their primary purpose was to raise capital, which was necessary to keep the company going. This was rejected on the evidence before him by Street C.J., who found that, although the directors had not acted "to gain some personal advantage for themselves by way of retention of their seats on the board or by obtaining a higher price for their personal shareholding"[79], their actions had concerned the "majority bloc in the share register. Their intention was to destroy its character as a majority…The ultimate purpose was to procure the continuation by Howard Smith's of the takeover offer made by that company."[80] The board's motivation had gone beyond "considerations of management, within the proper sphere of the directors."[81] The outcome of the case turned on this finding of fact.

On appeal to the Privy Council, Lord Wilberforce referred to the need for a "wider investigation"[82] into "the state of mind those who acted, and the motive on which they acted… collecting from the surrounding circumstances all the materials which genuinely throw light upon that question of the state of mind of the directors so as to show whether they were honestly acting in discharge of their powers in the interests of the company or were acting from some bye-motive, possibly of personal advantage, or for any other reason."[83] Factual complexity means that it is impossible to "define in advance exact limits beyond which directors must not pass".[84]

The ratio of the case is that "it must be unconstitutional for directors to use their fiduciary powers over the shares in the company *purely* for the purpose of destroying an existing majority or creating a new majority which did not previously exist."[85] The use of the word "purely" is absolutely crucial.[86] Where the board exercises their

79 [1974] A.C. 821, at 831.
80 *Ibid.*, at 833.
81 *Ibid.*, at 837.
82 *Ibid.*, at 834.
83 Lord Wilberforce approved this dictum of Viscount Finlay in *Hindle* v. *John Cotton Ltd* [1919] 56 Sc. L. R. 625, at 630–1.
84 [1974] A.C. 821, at 835.
85 *Ibid*, at 837; emphasis added
86 The leading Australian case of *Mills* v. *Mills* [1938] 60 CLR 150, HCA, provides some indication of the route the common law might have taken in dealing with multiple motivations on the part of the board. Dixon J. referred to "the substantial object, the accomplishment of which formed the real ground of the board's action…if, except for some ulterior and illegitimate object, the power would not have been exercised, that which has been attempted as an ostensible exercise of the power will be void, notwithstanding that the directors may incidentally bring about a result which is within the purpose of the power and which they consider desirable." This is generally interpreted as requiring an impermissible purpose to be "causative" of the exercise of the power in order for it to be voidable.

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powers of management primarily for – what the court finds on the facts of a particular case to be – a proper purpose, they do not breach their fiduciary duty if they incidentally affect balance of voting power in the general meeting.[87]

C. The Effect of the Common Law Rules

Both *Hogg* and *Howard Smith* establish that the question of purpose must be established *before* the question of the effect of the decision on the shareholders' rights – or the viability of a takeover - is addressed. Since many actions taken in the ordinary course of management may affect shareholder rights, their effect only becomes relevant where the board's primary purpose was the improper one of interfering with their rights. If the board's action was primarily referable to their general task of managing the company, any effect on shareholder rights is irrelevant. In neither case was it in any doubt on the evidence that the board's motivation had been improper. But in every case the question of propriety will be a matter of fact and of evidence. The fact that a takeover bid is either imminent or known to the board is not decisive of the legality of the action in question; it is merely part of the evidentiary matrix to be weighed alongside other issues in finding the facts.

Therefore, the common law rules emphatically do not deprive the board of its powers of management in the event of a takeover, nor do they amount to an absolute prohibition on defensive measures.[88] Instead, these cases impose an evidentiary burden on the claimant to show that the *primary* purpose for which the directors used their powers was an improper one, for example because they were directly motivated by maintaining their positions on the board or their control

[87] The common law's notion that the directors' powers and duties continue even in the face of a takeover bid is confirmed by *Dawson International plc* v. *Coats Patons plc* [1988] 4 B.C.C. 305 (Court of Session (Outer House)). Here the pursuers were seeking to recover the wasted costs of their abortive takeover bid. Lord Cullen emphasised that "The interests of the company and of the shareholders as prospective sellers might well diverge." He did "not accept as a general proposition that a company can have no interest in the change of identity of its shareholders upon a take-over. It appears to me that there will be cases in which its agents, the directors, will see the take-over of its shares by a particular bidder as beneficial to the company. For example, it may provide the opportunity for integrating or obtaining additional resources. In other cases the directors will see a particular bid as not in the best interests of the company…" He concluded that "The directors are not normally the agents of the current shareholders…This must not be confused with their duty to consider the interests of the shareholders in the discharge of their duty to the company…Directors have but one master, the company." One might even use this case to support an argument that, at common law, and subject to factual evidence, the board is free to issue shares to a potential bidder if they consider that that bidder's plans for the company are in the interests of the company as a whole.

[88] It is a common misconception that the City Code simply replicates the proper purposes rule. See for example, *Modern Company Law for a Competitive Economy – The Strategic Framework* (London, DTI, February 1999), URN 99/654 at 47: "Under the present law and practice directors are prevented by the "proper purpose" principle, and, in the case of takeover offers for public companies resident in the UK, by the City Code on Takeovers and Mergers, from exercising their powers in a way which frustrates the bid."

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over the company. This is clearly not an unbearable evidential burden, but it is a burden nonetheless. In a given case, it may be easily discharged. Where an aggrieved shareholder is able either to produce evidence that the board had acted primarily to prevent the takeover and maintain control, or to persuade the court that what the board knew of the offeror's plans made preventing the takeover their most likely primary purpose, the action would be likely to be held in breach of duty. More generally, the absence of similar initiatives in the past to act "in the interests of the company as a whole" by, for example, benefiting the employees, would open up a strong argument that preventing the takeover was the real reason behind the initiative. Similarly, in situations where the board knows about a bid, the conflict of interest to which they were exposed would also weigh heavily in the evidential balance.

The way in which the common law regulates managerial conduct during takeover bids is entirely consistent with its general policy of defending managerial autonomy against the demands of shareholders.[89] The business judgement rule is the law's recognition that the courts should not, as a general rule, interfere with the way in which the board exercises its discretion to run the business. Their discretion is limited only by general fiduciary principles, which do not apply any differently simply because a takeover bid has been made. However, since *Hogg*, the common law has had little opportunity to refine its treatment of takeover defences.[90] The introduction of the City Code effectively stemmed the flow of litigation to the English courts.[91] The City Code prohibits measures that hinder takeovers, and they are swiftly and pre-emptively dealt with by the Takeover Panel. Deprived of cases to consider, the courts had no opportunity to refine their approach. They might, for example, have developed a rebuttable presumption that, once the board has notice of a bid then actions that make the bid less likely to succeed are for an improper purpose. It would then be for the board to adduce contrary evidence of purpose. For example, if the board were able to produce evidence that they had discussed, but not carried out, the establishment of a trust for the employees *before the bid was imminent* then the claimant would have to discharge the full burden of proof.[92]

[89] Originating with *Automatic Self-Cleansing Filter Syndicate Co Ltd* v. *Cunninghame* [1906] 2 Ch. 34, CA.

[90] The *Howard Smith* case was exceptional, arising from an appeal to the Privy Council from the Supreme Court of New South Wales.

[91] Another relevant factor is the introduction of statutory pre-emption rights in response to the Second European Directive on Company Law, which meant that the abuses that formed the subject-matter of these cases no longer had to be decided as issues of directors' duties. Pre-emption rights can now be found in ss561 et seq Companies Act 2006.

[92] While the City Code would not prevent this type of anticipatory defensive measure, the likely adverse reaction to this on the part of capital markets, and its impact on the share price would

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V. The Emergence of the City Code

With incumbent management increasingly willing to take defensive measures,[93] the costly and unpredictable approach taken by the courts was not acceptable to powerful institutional investors. They recognised that, although only around 20% of takeovers were hostile,[94] the mere threat of hostile takeover exerted a powerful influence on corporate management to increase payouts to shareholders. With renewed threats from the Government to regulate takeovers by statute,[95] the City's reputation as an investor-friendly environment was coming under threat. It was clear that something more was called for.

In August 1967, following discussions between the Chairman of the Stock Exchange and the Governor of the Bank of England, the Issuing Houses Association reconvened the City Working Party which had produced the Notes. The drafting committee met during October 1967 and drew up a draft "Code" which, following amendments and approval by all the associations, was published and came into effect on 27th March 1968.[96] In light of the lack of respect shown to the Notes, a "Panel" was established to supervise the administration of the Code and give authoritative rulings and advice on its application. Those interpretations were to follow the spirit of the Code and avoid legalistic interpretations. The Panel commenced operations on the same date and in its first year of operation it was very busy: in its first twelve months, it handled some 575 cases.[97]

The City Code consisted of ten General Principles and 35 rules and was far more comprehensive than the Revised Notes. The Code required similar treatment of shareholders of the same class, equality of information to all shareholders and the offeree board to provide their shareholders with their opinion on the bid.[98] There is little dispute

make directors heavily remunerated with stock options likely to think twice about this type of action.

[93] See Johnston (above note 47), at 32–6.

[94] Hannah (above note 4), at 149.

[95] Prentice (above note 66), at 387. Black refers to the emergence of the City Code as an example of "coerced self-regulation, in which the industry itself formulates and imposes regulation but in response to threats by the government that if it does not the government will impose statutory regulation": see J. Black, "Constitutionalising Self-Regulation" (1996) 59 M.L.R. 24, at 27.

[96] Johnston (above note 47), at 38.

[97] *Ibid.*, at 42.

[98] The obligation on the offeree board to provide their opinion to their shareholders represented a significant improvement, from the shareholders' point of view, on the common law position, which only required that directors should be honest and not mislead if offering their opinion on the takeover to shareholders: see *Gething* v. *Kilner* [1972] 1 All E.R. 1166, [1972] 1 W.L.R. 337. The incumbent board's opinion would be of considerable importance to the target shareholders because of their detailed knowledge of the position and prospects of the business, and so, when combined with the common law duty, this provision of the City Code considerably improved the ability of target company shareholders to make informed decisions. The common law is not well equipped to impose affirmative duties of disclosure on directors, particularly given that it does not in general impose fiduciary duties on directors towards individual shareholders. Rule 25.1 of the current version of the City Code requires the Board of the offeree to provide offeree shareholders with their opinion of the offer together with the independent advice they have

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however that the most important provision introduced by the City Code was the principle which prohibited the board of the target company, once it became aware of a bid, from doing anything to frustrate the offer without general meeting approval.[99] Rule 38 provided more detail, specifically prohibiting, once an offer was made or the directors had reason to believe that one might be imminent, the issue of shares, the acquisition or disposal of assets of a material amount and the entry into contracts outside the ordinary course of business. On the other hand, defensive ploys such as asset revaluation and promises of bigger dividends in the future were "not only permitted, but almost positively encouraged."[100] The choice of permitted defensive measures demonstrates that the City Code was aimed squarely at improving the position of shareholders. It was already clear to commentators that the Code "comes down firmly on the shareholders' side" and "will impinge on the freedom of boards and persons involved in takeovers and mergers."[101]

This prohibition on defensive measures remains virtually unaltered in the current version of the Code. Rule 21.1(a) prohibits the board, "without the approval of the shareholders in general meeting", from taking "any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits". This is a very wide provision which applies both during the course of a bid, and before a bid is launched where directors have reason to believe that one "might be imminent". Furthermore, certain aspects of their managerial powers are explicitly truncated: they may not "(i) issue any authorised but unissued shares or transfer or sell, or agree to transfer or sell, any shares out of treasury; (ii) issue or grant options in respect of any unissued shares; (iii) create or issue, or permit the creation or issue of, any securities carrying rights of conversion into or subscription for shares; (iv) sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount; or (v) enter into contracts otherwise than in the ordinary course of business."[102]

This prohibition is absolutely central to the operation of the City Code. No longer would the ability of directors to defend against

received (which has been required since the 1976 amendments). The Rule also details a number of issues that their opinion should consider and requires reasons to be given for the opinion. This too represents an improvement on the common law position.

[99] Principle 4 and Rule 38 of the Code. For the prohibition on defensive measures in the latest edition of the Code, see General Principle 3 and Rule 21. Prentice (above note 66) comments at 409 that "[p]erhaps the primary factor contributing to the introduction of the City Code was the use, by the directors of offeree companies, of what were considered improper defensive measures against takeovers."

[100] Prentice (above note 66), at 409.

[101] Moon (above note 29), at 137.

[102] Rule 21.1(b).

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hostile takeover depend on a long and complex factual inquiry into their motivations. The nebulous common law test was replaced with a clear rule that ensured the shareholders would decide on the outcome of any bid, with no risk of delay by litigation and possible adverse publicity.

The Code was revised in 1969. While the Revised Code added a new general principle to the effect that the spirit as well as the letter of the Code should be observed, the lack of sanctions remained a major concern. Putting the Code and the Panel on a statutory basis was rejected, so the only sanction remained that of public censure by the Panel, while the associations behind the drafting of the Code could expel the wrongdoer if he happened to be a member. The Panel issued a Policy Statement in 1969 that they would censure wrongdoers, and that, in the case of flagrant breaches, they would take further action to deprive the wrongdoer of his ability to practise in the field of takeovers and mergers.[103] This was backed up by the Stock Exchange and other institutions, which supported the Panel and agreed that they would take action in the event of the Panel concluding that wrongdoing had occurred. The main way in which the Panel ensured compliance was through pressure on the investment banks which advised all parties in the context of a takeover bid; it was against them that the sanction of withdrawal of access to the City would bite hardest, and so they ensured that their clients complied with the Code. The generalised compliance that followed the introduction of the City Code demonstrates that the threat to withdraw access to financial resources to wrongdoers was a highly effective one.[104]

The next major change came in 1972. Although the original Notes had sought to ensure that there should be no interference in the free market in company securities, there was growing concern about ‘‘creeping’’ acquisitions of control through market purchases. After the introduction of the Code in 1968, the Panel had used an expansive interpretation of Rules 10 and 26, which applied to sales of control by directors and partial bids, to require those acquiring significant blocks of shares to make an offer on the same terms to the remaining shareholders. Nevertheless, it was widely recognised that bidders were acquiring control through market purchases before a formal bid was made. Furthermore, the introduction of capital gains tax in 1965,

[103] Johnston (above note 47), at 56.

[104] As Coase comments in relation to self-regulation on the part of commodity exchanges, in which agreement on the rules is obtained from all members, ‘‘enforcement of the rules is possible because the opportunity to trade on the exchange is itself of great value and the withholding of permission to trade is a sanction sufficiently severe to induce most traders to observe the rules of the exchange.’’ See R. Coase, *The Firm, the Market, and the Law* (Chicago 1990), at 10. Until the City Code was endorsed by the FSA and annexed to the Listing Rules, its regulatory viability depended entirely on the credibility of this threat.

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coupled with a rising stock market, had made bids that offered paper consideration more popular. The value of the paper that was being offered was a matter of concern, in particular where control had already been acquired on the market, leaving the offeree shareholders in the invidious position of either having to accept paper consideration of dubious value or remaining as vulnerable minority shareholders.[105] There was also concern about the practice of "warehousing", where a number of apparently independent parties were buying up shares at a level insufficient to trigger the statutory obligation to disclose ownership,[106] but where the total holding of those acting "in concert" would be crucial in a takeover bid.

In response to these concerns, the Code was amended to require disclosure of holdings of concert parties in offer documents. In 1972 a new Rule 29B was issued and brought into immediate effect that any person (including those acting in concert with him) who acquired shares that carried him or them across the threshold of 40 per cent of the voting rights had, within a reasonable time, to make an unconditional offer to the holders of the remaining equity at the highest price paid by that person on the market during the previous year. The revised code issued in 1972 incorporated this amendment, and also required anyone purchasing sufficient shares from the directors or a limited number of sellers to confer effective control to make a bid for the remaining share capital. The practice of the Panel came to be to regard a holding of 30% as sufficient to confer effective control; where this was held by the directors, the bidder would effectively be stepping into their shoes if they purchased the shareholding.[107] The reason for the difference was that open market purchases were a harder way of acquiring control. However, the two standards caused difficulties in administration because control obviously depends on the size of other blocks. In 1974 the Code was amended again so that there was a single mandatory bid rule, requiring a bid where any person (together with those acting in concert with him) acquired shares resulting in him having 30% or more of the voting rights in a company, or where they already held between 30% and 50% of the voting rights, they increased their holding by more than 1% in any period of twelve months.

[105] See further Johnston (above note 47), at 68. The rules requiring information and opinions on the merits of the bid are clearly aimed at enabling informed shareholder decision-making in circumstances in which the target shareholders would remain as shareholders in a merged enterprise after the bid.

[106] As recommended by the Jenkins Report, section 33 of the Companies Act 1967 required any shareholder holding more than 10% to disclose his interest publicly. This was lowered to 5% by the Companies Act 1976. See further D.D. Prentice (1977) 40 MLR 314, at 318–9.

[107] See Johnston (above note 47), at 91–2.

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While a mandatory bid rule that requires equal treatment of all shareholders certainly represents a restriction on the operation of the market for company shares, it can be justified in terms of its effect on the position of minority shareholders. The requirement for a mandatory bid ensures that a premium is actually paid for the acquisition of control, while the equal treatment aspect ensures that all minority shareholders share in that premium. The common law had not insisted on equal treatment of shareholders, as sales of shareholdings were considered a private matter with no implications for those outside the contract. Thus where a bidder could purchase a controlling shareholding or a large minority block in a private sale before launching a bid, the remaining shareholders would find that their shares were valued on the basis of being a minority stake only.[108] Nor had the common law concerned itself with regulating transfers of corporate control. The continued absence of such rules would have discouraged portfolio diversification. Since minority shareholdings would trade at a discount to reflect the fact that they would not share in any control premium, investors would be less willing to purchase minority stakes in companies, and so shares would trade at lower prices. This in turn might be expected to lead to an increase in companies' cost of capital, to the extent that they use the stock market to raise finance.

The City Code has been amended frequently since its introduction in 1968, but its key provisions, as described above, have not been altered in substance. In response to the requirements of the European Takeover Directive,[109] which was adopted in 2004, the Government decided that the Panel should be placed on a statutory footing for the first time and provisions to that effect were included in the Companies Act 2006. Those statutory provisions – which are now in force[110] - are designed to ensure the continuance of the perceived advantages of a

[108] In *Re Grierson, Oldham & Adams Ltd* [1968] Ch. 17, the applicant had sought to challenge a squeeze-out under s.209 CA 1948, arguing, inter alia, that the price that was being offered did not reflect the value to the bidder of acquiring control. Plowman J. held that "it is not unfair to offer a minority shareholder the value of what he possesses, i.e., a minority shareholding… the element of control is not one which ought to have been taken into account as an additional item of value in the offer of these shares." (35–7).

[109] Directive 2004/25/EC of 21 April 2004 (O.J. 2004 L142/12).

[110] The Takeovers Directive (Interim Implementation) Regulations 2006 (S.I. 2006 No. 1183) came into force on 20th May 2006. Given that the Companies Bill was still under discussion in Parliament, these Regulations implemented the Directive on an interim basis and gave statutory effect to the Code in relation to transactions and rules subject to the requirements of the Directive. Reg 2(1)(b) of The Companies Act 2006 (Commencement No. 2, Consequential Amendments, Transitional Provisions and Savings) Order 2007 (which was laid before Parliament on 8th February 2007, and is expected to be S.I. 2007/5771) brought sections 942 to 992 and Schedule 2 of the 2006 Act, which relate to takeovers, coming into force on 6th April 2007. Those powers will extend to all transactions to which the Code currently applies and the 2006 Regulations will cease to have effect.

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self-regulatory approach,[111] while allowing the Panel, for the first time, to impose sanctions directly on wrongdoers.[112]

The Takeover Directive requires the Member States to designate competent authorities for the supervision of bids and to equip them "with all the powers necessary for the purpose of carrying out their duties, including that of ensuring that the parties to a bid comply with the rules made or introduced pursuant to this Directive".[113] To this end, section 942(1) Companies Act 2006 grants statutory functions to the "body known as the Panel on Takeovers and Mergers" but makes no change to its composition.[114] With one important exception, the Panel's current de facto jurisdiction to make and interpret rules relating to takeovers and mergers is preserved by sections 943(2) and 945.[115] That exception is to be found in section 943(1), which obliges the Panel to make rules giving effect to certain articles of the Takeover Directive,[116] including in particular the optional Article nine,[117] which requires Member States to impose a prohibition on defensive measures by management. While it is inconceivable that the Panel would ever have chosen to remove the prohibition on defensive measures, Parliament has chosen, in implementing the directive by these sections, to require the Panel to maintain that broad prohibition.

Despite these recent statutory changes, it is submitted that the City Code should, on balance, still be considered a self-regulatory instrument. As we will see below, the Directive did not require any

[111] See "Implementation of the European Directive on Takeover Bids – A Consultative Document" (London, DTI, 2005, URN 05/511), which at paragraph 2.19 refers to "the objective of maintaining the advantages of the current regime". See also "Implementation of the EU Directive on Takeover Bids: Guidance on changes to the rules on company takeovers" (London, DTI, February 2007, URN 07/659).

[112] Section 952 Companies Act 2006 gives the Panel power to impose sanctions on wrongdoers. Before this, the Panel had to rely on public censure of wrongdoers or on the FSA, which had endorsed the City Code under s143 of the Financial Services and Markets Act 2000, taking action at its request against "authorized persons".

[113] See Articles 4 and 5 of the Takeover Directive (above note 109)

[114] The Panel continues to regulate its own composition. It appoints its "independent" members, who are drawn from major business and financial institutions, on the recommendation of its Nomination Committee. In addition, a number of institutions nominate members of the Panel, including the Association of British Insurers, the British Bankers' Association, the Confederation of British Industry, the National Association of Pension Funds and a number of other City institutions.

[115] Section 945 allows the Panel to give rulings on "the interpretation, application or effect of rules". It was recognised that structural changes would be required to "ensure a clear and transparent division of responsibilities between the various organs of the Panel in its executive, judicial and rule-making roles." (See "Implementation of the European Directive on Takeover Bids" (above note 111), paragraph 2.22.) The latest report from The Takeover Panel confirms that the Panel is now divided into the mutually exclusive "Hearings Committee" and "Code Committee". See "The Takeover Panel: Report and Accounts for the Year Ended 31 March 2006", available online at http://www.thetakeoverpanel.org.uk/new/reports/DATA//Report2006.pdf (checked 26th March 2007).

[116] Section 943(1) states: "The Panel must make rules giving effect to Articles 3.1, 4.2, 5, 6.1 to 6.3, 7 to 9 and 13 of the Takeovers Directive."

[117] The 2006 Act does not mention Article 12, which allows the Member States to reserve the right not to require companies to apply the rule against defensive measures and was absolutely crucial to the adoption of the directive.

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significant changes to the provisions of the City Code, and its implementation merely had the effect of freezing some of the Code's most important provisions. The reason for this is that, as a historical matter, the contents of that Directive were modeled almost entirely on the provisions of the City Code. These are precisely the provisions that the Panel, which remains representative of financial institutions, would have been least likely to alter. Aside from these frozen provisions, the Panel still has broad discretion to make rules regulating the conduct of takeovers.

VI. Theoretical Perspectives on the City Code

The argument that, when compared with traditional top-down regulation, the City Code offers significant regulatory advantages is an attractive one. The changes made to the Code over time demonstrate the flexibility and responsiveness of self-regulation. The Panel is able to react quickly to perceived abuses by making rule changes, as it did by imposing restrictions on those acting in concert or on creeping acquisitions of control. It interprets the General Principles according to the spirit of the Code, rather than legalistically, and applies the rules to an endless variety of factual situations. Since the Panel is made up of experts in the field, they are immediately up to speed on the relevant considerations and the general ethical norms that apply to takeovers. The very nature of self-regulation means that the rules are almost certain to command broad assent of those they regulate, as those charged with making and enforcing the rules are drawn from among the regulated.[118] Finally, the administrative costs of regulation are borne by practitioners in the regulated field.[119] It seems clear that the flexible nature of the Panel's new statutory basis should enable these advantages to be retained.

Before the implementation of the Takeover Directive, the City's self-regulatory capacity was built upon a combination of legislative inactivity and its ability to deny access to its markets to those who flaunt the rules. As a measure of self-regulation, the Code was commonly presented as a purely technocratic instrument, elaborated and administered from within the capital market system. In terms of content, nothing has changed since the Directive was implemented, although some of the Code's provisions now have Parliamentary approval. The dominant theoretical view of the City Code remains that it is both a regulatory solution to a market failure,[120] and that it

[118] See J. Black, *Rules and Regulators* (Oxford 1997), at 36.
[119] Ogus (above note 1), at 98.
[120] In the case of the Code this would be correcting the market outcome that minority shareholders do not share in the takeover premium because of the possibility of creeping acquisitions, which in turn would discourage investors from diversifying their portfolios.

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ensures managerial accountability to shareholders without creating any externalities for third parties. There is no doubt that, for the most part, this is true. The City Code does ensure that small shareholders share in any premium that is paid for the acquisition, and much of the City Code simply benefits dispersed shareholders. In particular, the requirement of equal treatment and other procedural protections provided to shareholders affect only them and provide support for the claim that the City Code imposes standards that are considered ethical by practitioners.

Recent theoretical debates in corporate governance have seen a sustained challenge to the dominant view that the City Code does not create any externalities. The critique focuses on the absolute prohibition on defensive measures by management, and contends that it has had a deleterious effect, from an economic perspective, on companies' relationships with key stakeholders, and their employees in particular. Part A below sets out the orthodox economic view of the City Code. Part B discusses the challenge to that view, and in particular, to the view that the prohibition on defensive measures is necessarily economically efficient. Part C concludes the article with an examination of the extent to which these recent theoretical debates have been reflected in policy discussions and regulatory reform.

A. The Agency Model and the Market for Corporate Control

Unsurprisingly, given the identity of its drafters, the provisions of the City Code receive broad support from supporters of a purely financial conception of corporate governance. Very briefly, the "agency" or "neoclassical" model of corporate governance deconstructs the corporate entity to reveal a "nexus of complete and incomplete contracts", at the centre of which is the board of directors, acting as the agents of the shareholders.[121] Among the various parties to these contracts, only the shareholders have a residual claim, which entitles them to whatever is left over after all the other constituencies have been paid in accordance with their contracts. As residual claimants subject to uncertainty about the future, the shareholders are unable to specify in advance in legally binding contracts the precise way in which the directors will advance their interests. This gives management scope to impose "agency costs" on the shareholders, costs that are reflected in the difference between the current market price of the company's shares and the premium offered by the bidder. Furthermore, although

[121] The literature on the agency model of corporate governance is vast. For a useful starting point, see, for example, F. Easterbrook and D. Fischel, *The Economic Structure of Company Law* (Cambridge, Mass. 1991) , Chapter 1 or M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 Journal of Financial Economics 305.

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shareholders receive rights to appoint and remove the board, to attend meetings and receive information, collective action problems make it rational for dispersed shareholders not to expend resources holding management to account.[122] This leads to the normative argument that the system of corporate governance should provide additional mechanisms that ensure accountability of management to shareholders. Such mechanisms will be efficient because they will ensure that the value of that variable residual claim will be maximised, and with it the wealth of society. By contrast, employees, creditors, suppliers and other corporate constituencies are no concern of the corporate governance system because they are able to protect themselves by fully binding contracts.[123]

During the 1960s merger wave, it was influentially argued that a market for corporate control was the key mechanism for ensuring managerial accountability to dispersed and passive shareholders, both through the threat and the actual execution of hostile takeovers.[124] Manne argued that potential bidders monitor the share price of public companies, looking for underperformance: "The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe that they can manage the company more efficiently."[125] For Manne, it was the realistic prospect of hostile takeover that would force management to prioritise the interests of shareholders, giving them "both power and protection commensurate with their interest in corporate affairs."[126] Faced with a bid, the shareholders should be allowed to decide whether to sell their shares at a premium above the current market price, or to keep the faith with incumbent management.

However, a market for corporate control cannot operate where company law allows management to take defensive action which delays or prevents prospective takeovers. Proponents of the agency model treat defensive measures as devices by which incumbent management entrench themselves at the expense of shareholder, and therefore social, welfare. More importantly, if the board is permitted

[122] See Easterbrook and Fischel (above note 121), at 171–2; B. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford 1997), at 62–4; J. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford 1993), at 54–6.

[123] Easterbrook and Fischel (above note 121), at 37: "It is all a matter of enforcing the contracts. And for any employee or investor other than the residual claimant, that means the explicit, negotiated contract."

[124] H. Manne, "Mergers and the Market for Corporate Control" (1965) 73 J. Pol. Econ. 110; R. Marris, *The Economic Theory of Managerial Capitalism* (London 1964), especially at 18–20.

[125] Manne (above note 124). at 113. For a more recent restatement, see Easterbrook and Fischel (above note 121), at 172–3.

[126] Manne (above note 124), at 112. See also H. Manne and H. Wallich, *The Modern Corporation and Social Responsibility* (Washington, D.C. 1972), at 19), for Manne's argument that management can "use for their own purposes any rents produced by the corporation up to the amount it would cost to displace them from their positions."

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to take defensive measures, this threatens the viability of the takeover mechanism more generally: more bids will fail because of litigation, increasing the costs of outside monitors and making their operations less profitable, thus reducing the number of monitors and potential bidders.[127] Accordingly, regulation that prohibits defensive measures is required to ensure a constant supply of potential bidders.

Unlike, say, the law of Delaware, which subjects defensive measures to judicial scrutiny, the City Code meets this demand precisely. With its clear prohibition on defensive measures, public companies, whose shares are purchased in great quantities by institutional investors, are permanently "biddable". The constant background threat of takeover also has a positive effect on share prices generally, as the markets reflect this constraint on managerial discretion and the fact that, under threat of takeover, incumbent management tends to behave in a manner remarkably similar to successful bidders. Finally, when a bid is actually made, investors are able to exit from their holdings (which they may have been locked into by virtue of holding large, illiquid holdings) at a considerable premium.

However, mandatory bid rules like the one in the City Code meet with less approval. Critics argue that they undermine the market for corporate control in a manner similar to defensive measures.[128] The mandatory bid rule certainly prevents creeping acquisitions of control and ensures that all shareholders share in the control premium. In turn, this encourages portfolio diversification, which is desirable because it enables individual investors to bear a level of risk which is acceptable to them. However, the extra cost of bidding for the entire share capital of a company means there will be fewer takeover bids and therefore fewer changes in corporate control. This undermines the credibility of the threat of hostile takeover as a mechanism for forcing management to maximise the value of the shareholders' residual claim. We might conclude from this that, while the Code generally promotes the operation of a market for corporate control, the demands of minority shareholders to share in the control premium prevail over concerns about managerial accountability. These priorities reflect the fact that, historically, the primary concern of the drafters of the City Code was to maintain investor confidence in the City rather than to improve standards of corporate governance generally.

[127] Easterbrook and Fischel (above note 121), at 173–4.

[128] See for example, L. Enriques, "The Mandatory Bid Rule in the Takeover Directive: Harmonization Without Foundation" (2004) 4 European Company and Financial Law Review 440 at 448–9 and the sources cited there.

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B. Firm-Specific Investment and takeovers as Expropriation

A recent theoretical challenge to the dominance of the "agency" model suggests that the prohibition on defensive measures creates externalities for employees and perhaps other stakeholder groups.

One of the advantages claimed for a managerialist system of company law and corporate governance is that it offers a solution to the problem of encouraging employees to specialise their skills and make investments in firm-specific human capital.[129] Employees may be reluctant to invest in idiosyncratic skills that have less value in other contexts because it will expose them to the risk of the firm failing, and uncertainty about the future makes it impossible for companies to offer employees contractual protection for their investments.[130] Giving broad discretion to management offers a way around this impasse by giving them scope to establish informal arrangements or "implicit contracts."[131] Examples of these are career ladders and remuneration structures that reward seniority, as well as the common practice of firms paying employees below their marginal productivity in the early years of employment in order to recoup the expenses of training, but paying above-market wages in later years. This above-market remuneration reflects the additional productivity that results from the co-specialisation of employee skills and firm assets.[132] The key point is that, where implicit contracts are in place, the shareholders are no longer the only residual claimants.[133]

While not legally binding, implicit contracts are underpinned by social norms: management honours them, either because doing so enhances the company's reputation and so allows it to rely on implicit contracts in the future, or simply because, as a behavioural matter, they prefer to stand by their word. Implicit contracts constrain the

[129] For an introduction and very clear statement of this argument see Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (Washington D.C. 1995). A similar argument can be made in relation to companies' relationships with their suppliers, but is beyond the scope of this article.

[130] This is normally discussed in terms of transaction costs, and in particular, bounded rationality: see O. Williamson, *The Economic Institutions of Capitalism* (New York, 1985) at 18–32.

[131] The term "implicit contracts" emphasises the non-binding nature of these arrangements. O'Connor suggests that "implicit contracts are…social arrangements typically enforced through the operation of market forces." (See M. O'Connor, "Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers" (1990) 69 North Carolina Law Review 1189 at 1204–5).

[132] Economists discuss this phenomenon in terms of quasi-rents. Zingales explains that "The difference between what the two parties generate together and what they can obtain in the marketplace represents a quasi-rent, which needs to be divided *ex post*." See L. Zingales, "Corporate Governance" in P. Newman (ed), *The New Palgrave Dictionary of Economics and the Law* (Basingstoke 1998), 495 at 497. In other words, the quasi-rent is the increased profit which a particular relationship generates over and above what could be achieved by the deployment of the same assets in their next best use.

[133] Margaret Blair has estimated that "as much as 14 per cent of total wages and benefits paid to employees of corporations in the United States may represent a return to firm-specific human capital." See Blair (above note 129), at 266.

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extent to which management can maximize the shareholders' claim over corporate income and so from a shareholder perspective, "ousting the managers is a prerequisite to realizing the gains" available by breaching the implicit contracts.[134]

It is here that the hostile takeover enters the picture and undermines the viability of the implicit contract as a basis for stimulating specialisation within companies. Removal of the incumbent board following the takeover allows a wealth transfer from employees to shareholders to take place.[135] Those appointed by a successful bidder to replace incumbent management will not feel obliged to honour commitments made by their predecessors and are able to expropriate the employees' share of the quasi-rents by reducing their above-market wages, which are the deferred portion of their remuneration, to just above their opportunity cost.[136] Looking beyond the breach of trust involved in this situation, the "waves of takeovers, buy-outs, spinoffs, corporate reorganizations, restructurings, and downsizings"[137] undermine the credibility of commitments by companies to their employees across the economy as a whole. When employees generally become afraid of the consequences of hostile takeovers, they become reluctant to specialise.[138] This leads to a decrease in trust across the economy as a whole, which can only be partially cured by a greater use of legally binding contracts (which also dramatically raises transaction costs), or by paying employees more in the present in return for the increased uncertainty about future payments.[139]

In conclusion then, there is an important argument that takeovers which involve breach of implicit contracts are "rent-seeking and not value-creating exercises,"[140] which reduce social wealth through the destruction of non-redeployable investment and reduce the willingness of suppliers of factors of production across the economy to specialize to meet the needs of companies. This, it can be argued, is very

[134] A. Shleifer and L. Summers, "Breach of Trust in Hostile Takeovers" in A. J. Auerbach (ed.), *Corporate Takeovers: Causes and Consequences* (Chicago, 1988) at 41.

[135] Shleifer and Summers (above note 134) comment at 41, "Not surprisingly, then, takeovers that transfer wealth from stakeholders to shareholders must be hostile."

[136] Shleifer and Summers (above note 134) emphasise at 45 that where "the employee is costing the company more than he is contributing *at the moment*…his dismissal is a gain to the shareholders" Similarly, in order to free up cash flow, the new shareholders may make changes to operations and reduce investments in future projects that were not anticipated by the employees when they agreed to work for the firm.

[137] Blair (above note 129), at 259.

[138] The fear of hostile takeover may be greater than the actual risk as employees face uncertainty in identifying the types of firms which are at risk of hostile takeover. Since the share price appears to be the key determinant, and employees apparently have little or no influence over it, this may increase the fear that their future employment depends entirely on factors outside their control.

[139] See generally Shleifer and Summers (above note 134), at 46–53.

[140] Shleifer and Summers (above note 134), at 42.

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damaging to the UK's competitive advantage, which lies in high skill, high productivity operations.

What is to be done about the threat posed by the hostile takeover mechanism to these productive arrangements? For some US commentators, the credibility of informal commitments depends on management having a degree of entrenchment and independence from shareholder control.[141] This suggests a return to the norms of managerialism, and defensive measures in particular, that prevailed before the transformations brought about by the City Code. Of course, this would be anathema to the "agency" model as it would undermine managerial accountability to shareholders.[142]

While the "expropriation" explanation of the hostile takeover is not uncontested,[143] it does represent a significant challenge to the dominant assumption that an unfettered market for corporate control operates is wealth enhancing.

C. Towards a Reform of Takeover Regulation?

Regrettably, for the most part, arguments about firm-specific human capital investments and takeovers as expropriation have neither been

141 Margaret Blair and Lynn Stout argue that management should play the role of mediating hierarchs among the competing claims of the various constituencies: see for example M. Blair and L. Stout, "A Team Production Theory of Corporate Law" (1999) 85 Virginia Law Review 247. Quite how this "state of ivory tower autonomy" could be brought about by a legal framework is the basis of Millon's doubts about their approach: see D. Millon, "New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law" (2000) 86 Virginia Law Review 1001. While Blair's approach may have much to commend it in the US context, in which the market for corporate control is restricted by a variety of state-level regulations, it does not offer an adequate solution in the UK context, in which the market for corporate control is firmly entrenched by the City Code.

142 A less controversial suggestion is to be found in a recent paper from the Work Foundation dealing with the adverse consequences for employees resulting from the recent upsurge in highly-leveraged "private equity" takeovers. In "Inside the Dark Box: Shedding Light on Private Equity", Phil Thornton suggests that the Government should consider extending the protection of TUPE to situations in which undertakings are transferred through share purchases so as to ensure information, consultation and protection of the relevant employees. He also suggests (at 34) an obligation to provide information to the employees about "where the money comes from and who are the ultimate investors" to cure a gap in current information and consultation arrangements. Document available online at http://www.theworkfoundation.com/Assets/PDFs/private_equity.pdf(checked 26th March 2007).

143 See for example R. Romano, "A Guide to Takeovers: Theory, Evidence and Regulation" in K. Hopt and E. Wymeersch (eds) (above note 25), at 19, who emphasises the empirical difficulties of testing Shleifer and Summers' hypothesis: "we would need counter-factual data to test the labor expropriation hypothesis fully – we need to know how many workers would have been laid off of what the wage profile would have looked like if the firm had not been acquired." She also argues that the true motivation of management in making implicit promises to employees may be that they are averse to adversarial bargaining and so grant favourable terms to support comfortable relations between themselves and the company's employees, thereby ensuring corporate stability and increased leisure for themselves. Preventing this type of "empire-building" is one of the prime concerns of the agency model, which seeks to re-establish market control over resource allocation. Ultimately for Romano, the implicit contract is merely an evidentiary problem, "a contract whose terms are observable to the contracting parties, but not to third parties, such as courts and hence are not verifiable." However, it is submitted that this is not the claim advanced by advocates of the expropriation explanation; implicit contracts cannot be made fully explicit because of the uncertainty of the future, and in particular the level of quasi-rents that the relationship will generate.

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considered in policy debates nor taken into account in takeover regulation.

The City Code itself contains little in the way of recognition that employee interests may be adversely affected by takeovers. This is not surprising, given that employee representatives have never been involved with the Panel or drawing up the rules of the City Code. The main exception to this is Rule 24 of the current edition of the Code, which requires the offeror to disclose his intentions with regard to, inter alia, the "the future business of the offeree company", "its strategic plans for the offeree company, and their likely repercussions on employment and the locations of the offeree company's places of business" and "its intentions with regard to the continued employment of the employees and management of the offeree company and of its subsidiaries, including any material change in the conditions of employment." This rule first appeared in the Notes on Amalgamations, and was carried across into the City Code. In its Report of 1972–3, the Panel emphasised that it viewed the rule as "a most important provision of the Code" and that the "intentions of the offeror as to the future conduct of the offeree's business, and the likely effect of any such intentions on the future livelihood of the offeree company's employees, may be a significant factor for shareholders in deciding whether or not to accept an offer."[144]

Given the Code's general pro-shareholder orientation, the inclusion of this rule is perplexing. The best explanation seems to be that a statement of the offeror's intentions for the business is relevant where an offeror is offering paper consideration, or an option of paper consideration, for the acquisition. In that situation, offeree shareholders who accepted the paper would see their interest transferred into a merged enterprise under the control of the offeror's management and would be very interested in the potential "fit" between the two businesses. Viewed in this way, the provisions are entirely consistent with the Code's policy that shareholders should receive

[144] See 1972–3 Panel Report at 10. The Report is available online at http://www.thetakeoverpanel.org.uk/new/reports/DATA%5CReport1973.pdf (checked 2 April 2007). See also Johnston (above note 47), at 97 and 231. In 1974 the Rule was "extended and amplified" specifically to require the offeror to disclose "its intentions with regard to the continued employment of the employees of the offeree company." See 1973–4 Panel Report at 9. The Report is available online at http://www.thetakeoverpanel.org.uk/new/reports/DATA%5CReport1974.pdf (checked 2 April 2007). These amendments to the Code reflected changes in the requirements of the Stock Exchange that offerors should make more detailed disclosure of their plans for the business, including the continuing employment of the company's employees: see Johnston (above note 47), at 84. In order to comply with the EC Takeover Directive of 2004, recent editions of the Code have added further requirements as regards employee interests. Rule 25.1(b) now requires the offeree board to include in their opinion a statement of the likely effect of the bid on employment. Rule 30.2(b) requires the offeree board, if they receive it in time, to append the opinion of employee representatives on the effects of the offer on employment to their opinion. Rule 32.7 requires the offer document to be made available to the employees' representatives or the employees.

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sufficient information to make an informed decision on whether to sell their shares. However, from the perspective of the "expropriation" argument, relying on shareholders to consider the interests of employees in deciding whether to sell their shares at a premium will not suffice to internalise the interests of employees into the regulatory process. Perhaps these provisions of the Code should simply be viewed as a product of their time and an attempt to head off intervention in the self-regulatory process by the Labour Government that came into power in March 1974.[145]

The recent Company Law Review process did briefly examine the impact of takeover regulation on corporate governance generally.[146] The Steering Group acknowledged the risk that granting overriding priority to shareholder interests might undermine relationships of trust and increase "the level of inefficient risk between those managing companies and employees, suppliers and others, on whom the company depends for factors of production."[147] This formed part of a broader debate about the "scope" of company law, in which wholesale reform of company law on a more pluralist, stakeholder model was under consideration. In such a system, the board would be permitted to take account of a range of interests, independent of their effect on shareholder interests. It was implicit in the Steering Group's analysis that such a reform would have required significant changes to the current system of takeover regulation to ensure consistency.[148] Following public consultation, pluralist reform was eventually rejected on the grounds that its implications would be too far-reaching, and a compromise was reached in the form of "enlightened shareholder value", based on a more inclusive statement of directors' duties[149] coupled with an obligation on listed companies to produce an Operating and Financial Review ("OFR"), which would leave mechanisms that ensure management accountability to shareholders intact.

It was proposed that the OFR should contain qualitative information about, inter alia, corporate investments in and relationships

[145] Johnston (above note 47) argues at p.198 that "Since the law regards a company as belonging to the shareholders, the Code is primarily concerned with the protection of the interests of shareholders. If company law was altered to take greater account of the position of employees in a company, the Code would probably have to be amended to reflect the law." During this period there was strong pressure for industrial democracy, which culminated with the publication of the Bullock Report.

[146] See for example *The Strategic Framework* (above note 88), at 42–6.

[147] *The Strategic Framework* (above note 88), at 42.

[148] *The Strategic Framework* (above note 88), at 47–8.

[149] Section 172 of the Companies Act 2006 requires directors to have regard to, among other matters, employee interests as a means to the end of promoting "the success of the company for the benefit of its members as a whole". However, it is submitted that, with the wider corporate governance environment imposing the same pressures for short term returns, this provision, like its predecessor, s.309 Companies Act 1985, will have little – if any – influence on corporate decision-making.

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with employees, and was expected to elicit a less "short-termist" approach on the part of institutional investors by helping them gain a better understanding of the sources of wealth creation within companies. This in turn would allow companies more scope to pursue "enlightened" shareholder value by making investments in firm-specific human capital that would generate enhanced returns for shareholders in the longer term. This approach could be viewed as an innovative attempt at reflexive regulation, which acknowledges the autonomy of the capital market, but steers it towards internalising its effects on companies' relationships with their employees. The idea is that, if the capital markets have more qualitative information, share prices will reflect investments in idiosyncratic skills as wealth-generating assets rather than costs to be minimised.[150] However, for political reasons, the OFR was unexpectedly removed from the statute book and replaced with a "Business Review" which is considerably less prescriptive about, *inter alia*, the disclosure that must be made about employment matters.[151] The removal of the OFR means that, underpinned by the City Code, the market for corporate control is likely to operate exactly as before. This makes the failure of the Company Law Review to give more detailed consideration to takeover regulation and its possible reform all the more regrettable.

Finally, the recent implementation of the Takeover Directive offered an ideal opportunity to consider reform of takeover regulation. The UK was not obliged to maintain the prohibition on defensive measures: political agreement could only be reached at European level – after thirty years of negotiations – by abandoning the City Code model and making the prohibition optional. The delay in adopting the directive arguably demonstrated that a single system of takeover regulation is neither acceptable nor appropriate for every Member State, or even for every company within a single Member State.[152] The compromise reached in the directive gives Member States the option of not prohibiting defensive measures. If they exercise this option, they must allow individual companies voluntarily to adopt a prohibition on defences.[153] That decision must be taken by the shareholders in general meeting and notified to the supervisory authorities in the Member States where the company has its registered office and where its shares are listed.

[150] For a pessimistic assessment of whether the OFR would actually have achieved this goal, see A. Johnston, "After the OFR: Will UK Shareholder Value Still be Enlightened?" (2006) 7 European Business Organization Law Review 817.

[151] Johnston (above note 150), at 831–2. For the specific requirements of the Business Review, see s.417 of the Companies Act 2006.

[152] See A. Johnston, "The European Takeover Directive: Ruined by Protectionism or Respecting Diversity?" (2004) 25 Co. Law 270.

[153] See Article 12 of the Takeover Directive (above note 109).

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This option arguably reflects a *via media* between prohibiting and permitting defensive measures. Companies are permitted to take defensive measures – to the extent allowed under national law - unless their shareholders opt into the prohibition. If the UK had taken this option, there is no doubt that the institutional investors that dominate the share registers of UK listed companies would cause companies to opt in. Furthermore, management, who are heavily incentivised with share options that vest in the event of a takeover, would be virtually certain to use the proxies they control to opt for a prohibition. However, this more flexible approach holds out the prospect of allowing some companies more autonomy from short-term capital market pressures. As long as individual companies' choices are well publicised, the choice made by companies would be a clear signal both to prospective investors (thus affecting the share price) and to employees deciding whether to specialize their skills on the basis of implicit contracts (thus affecting productivity).

In its consultation document on the implementation of the directive, the Department of Trade and Industry did not seriously consider making the prohibition optional. That document emphasised that the prohibition was a "fundamental principle" protecting minority shareholders and that "[t]hroughout the negotiations on the Directive, important UK City and business stakeholders emphasised their support for article 9 and the principles underlying it".[154] It contained no discussion of any of the economic arguments against the prohibition, nor any discussion of the possibilities for making the prohibition optional and the way in which companies' choices should be publicised. While the public was consulted on whether the prohibition should apply, no record of responses is available. The Government's clear intention was that it should continue to be applied to all listed companies.

While it must be admitted that the majority of the Member States of the EC implemented the prohibition,[155] the policy question of whether management should be allowed to take defensive measures is a tough one. In the absence of a counterfactual, it is very difficult to prove conclusively whether a prohibition on defensive measures raises or lowers aggregate social welfare. Shareholders in target companies benefit through receipt of bid premia, and financial advisers, too, whomever they advise, benefit greatly from a high level of takeover activity. The position of shareholders in bidding companies is more ambiguous, especially where companies have a high share price that

[154] See *Implementation of the European Directive on Takeover Bids* at 3.6 (above note 111).

[155] See *Report on the Implementation of the Directive on Takeover Bids* (SEC (2007) 268), 21 February 2007) available online at http://ec.europa.eu/internal_market/company/docs/takeoverbids/2007-02-report_en.pdf (checked 4 April 2007).

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makes it easier to launch bids: while they may benefit from post-acquisition improvements in the management of the target company, they may also suffer from hubris on the part of their own managers. Continuous pressure from financial institutions on management to engage in deals may increase the risk to which they are exposed. Much effort has been devoted to the relative incidence of benefits among shareholder groups, and most studies have found that shareholders in the bidder make virtually no gains or suffer losses.[156] Beyond the requirement of Rule 23 that the offeror has an obligation to provide its own shareholders with information about the bid, the City Code does not offer bidder shareholders any protection.[157] Much less effort has been devoted to the harm that the prohibition does to employees and other stakeholders. We simply do not know whether the aggregate benefit of greater productivity and lower transaction costs that theory suggests would result from better protection of their implicit contracts would exceed the benefit received by target shareholders following a successful bid.[158]

What can be said with certainty is that the balance struck between shareholder value and stakeholder specialisation is (or should be) a question of public policy. Takeover regulation – whether by the City or the Government - is one of the methods by which the operation of the economy is steered towards different equilibria. The market for corporate control is the product of explicit choices rather than natural forces. Those choices should be the subject of debate, and it is regrettable that there was no theoretically informed public debate about the merits of maintaining the current prohibition on defensive measures. Such a debate could have expressly affirmed the prohibition on the basis that the gains to target shareholders and the financial industry outweigh any consequential reluctance to specialise on the part of employees.

[156] See, for example, G. Jarrell, J. Brickley and J. Netter, "The Market for Corporate Control: The Empirical Evidence since 1980" (1988) 2 Journal of Economic Perspectives 49, concluding at p.66 in relation to the US data from the 1980s that "[a]cquirers, however, receive at best modest increases in their stock price, and the winners of bidding contests suffer stock-price declines as often as they do gains." See also M. O'Sullivan, *Contests for Corporate Control* (Oxford 2000) at 168–9 and the sources cited there.

[157] Protection for bidder shareholders against "empire-building" on the part of management is to be found in the Listing Rules, Rule 10: see above note 69. Bradley suggests that the law would probably deploy the proper purposes rule against acquisitions that were designed to entrench incumbent management by increasing the size of their company: see C. Bradley, "Corporate Control: Markets and Rules" (1990) 53 M.L.R. 170, at 180–1. However, this would involve the same kind of evidential problems discussed above in relation to controlling defensive measures, and a minority shareholder who wished to challenge the action would face formidable procedural and substantive obstacles to bringing a derivative action.

[158] The only academic discussion that addresses this question is the debate on "varieties of capitalism", which emphasises the institutional complementarities between, for example, the configuration of takeover regulation, managerial discretion and employee specialisation. However, direct comparisons between jurisdictions are inadvisable because of the number of variables that interact to produce the results: see, for example, the collection edited by P. Hall and D. Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford 2001).

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Alternatively, it could have rejected imposing the prohibition on all companies on the grounds that the competitive environment in which the UK finds itself requires more employee specialisation.

VII. Conclusion

The recent explosion of leveraged takeovers by private equity firms makes the question of takeover regulation more topical than ever. Roberts suggests that "by handing over regulation to City practitioners the authorities ensured the least restrictive form of regulatory regime… by then the authorities had come to regard take-overs as a means of promoting industrial rationalisation and instilling discipline in management."[159] The Takeover Panel retains a broad discretion to regulate takeovers, despite the fact that some aspects of takeover regulation are now dictated by statute. As a result of the way the City Code fed into the Takeover Directive, even the statutory aspects of the Code reflect the preferences of financial investors and the aims and history of the City Code.

The way in which takeovers are regulated raises fundamental questions about the nature and scope of company law and corporate governance. A tension between two different conceptions has existed at the heart of company law for a long time. The narrow, financial conception seeks to ensure accountability of the board to shareholders, whether directly through their right to appoint them, or indirectly, through the operation of the market for corporate control and other incentives. The managerial conception emphasises managerial responsibility for developing corporate resources and autonomy from shareholder demands. If managers cannot defend against hostile takeovers that they consider objectionable, and the company can always be sold from under them by the shareholders, they will be unable to generate the commitment from stakeholders that delivers enhanced productivity and ultimately, returns for shareholders. The outcome of the recent company law reform appears, at least rhetorically, to be a decisive turn away from managerialism in favour of shareholder value. At the same time, the broader constraints of the corporate governance system remain firmly in support of shareholder value.

This article has sought to demonstrate that the hostile takeover is a product of regulation, and that allowing it to operate freely should be viewed as a policy choice. While reform of takeover regulation is almost inconceivable at the moment, there is a need for more debate about the wider economic impact of takeovers and about the regulatory choices that have been made.

[159] Roberts (above note 24), at 197.

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