Regulation of takeover bids in the European Union

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The first section of this paper provides a general background regarding the economic integration in the European Union, as well as the economic context of the adoption of the EU legislation regarding takeover bids (Directive 2004/25 of the Council and the European Parliament on takeover bids[1]). The second section gives an overview of the main policy considerations and regulatory objectives of the Directive, the third section shortly presents its regulatory history. The forth section explains its main provisions and the objectives pursued by these rules. The conclusion provides a brief assessment of the likely effects of the Directive.

Introduction

The purpose of this paper is to provide an overview of the objectives and main lines of the European rules and principles on takeover bids. These rules constitute the general framework of the legislation on takeover bids in all[2] EU Member States. It has been prepared with a view to provide assistance to the Korean Government in its work to develop an appropriate regulatory framework for takeover bids.

1. Economic construction of the European Union, the economic context of the adoption of common EU rules on takeover bids

The economic construction of the European Union is based on three pillars. The **Single Market** designed to improve economic efficiency of the European economy; an effective **monetary arrangement**, to ensure monetary stability[3]; and a **Community budget**, to foster cohesion between EU Member States[4].

All three pillars were gradually put in place. **The Single Market** is designed to remove barriers to the cross-border flow of persons, goods, services and capital among the Member States of the European Union. The single market policy had beneficial effects in promoting competition through, among others the liberalisation of certain sectors, such as telecommunication or energy, which had previously operated as monopolies and the integration of others.

Several fundamental rules in the area of the single market affect directly the way in which a takeover can be carried out in the EU. The next paragraph presents some of these basic rules.

Single market rules affecting takeovers

1) **Free movement of capital**

The first set of rules **determines the extent to which Member States** (i.e. national governments and authorities) **can intervene in cross-border takeovers** or maintain arrangements (e.g. shares providing specific rights, such as a veto right to the State as regards the acquisition of a certain percentage of the shares in the company) which may affect the outcome of takeover bids.

[1] Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004L0025:EN:NOT
[2] The EU takeover rules have to be transposed into national law. This transposition process is still ongoing in a few Member States, such as Italy and Spain, however transposition is expected soon.
[3] A European monetary union was set up in 1999 and the single currency was introduced in 2002.
[4] The Community budget and the share allocated to cohesion were gradually expanded.

The Treaty on the European Community[5] defines the fundamental rules of the single market and constitutes the legal basis of all the legislative measures adopted by the European institutions.

The relevant Treaty provisions governing the freedom of capital movements are enshrined in Articles 56 to 60 of the EC Treaty. Article 56 provides that **''all restrictions on the movement of capital between Member States shall be prohibited''. The principle of free movement of capital and payments, as foreseen in Article 56 of the Treaty, applies to capital flow within the EU as well as to capital flows from third countries[6].**

Free movement of capital means that citizens and companies should be able to carry out a number of operations in another Member State, such as freely buying shares in non-domestic companies, investing where the best return is, and taking an active part in the management on non-domestic firms.

Under the terms of the Treaty provisions, Member States can prohibit or block cross-border capital flows or capital flow originating from persons established in a third country only in specific circumstances, such as for the purpose of protecting national security. A large body of law has been developed through the interpretations given by the European Court of Justice to these Treaty articles[7]. The Court has substantially restricted the ways in which Member States can legitimately maintain rules or arrangements which restrict cross-border capital flow, e.g. by providing that the measures aiming to protect national security cannot go beyond what is absolutely necessary and must be suitable for attaining the objective pursued. See in this respect Case C 503/99 Commission / Belgium: Rights attaching to the 'golden shares held by the Kingdom of Belgium in Société nationale de transport par canalisations SA and in Société de distribution du gaz SA[8].

2) **Competition policy - merger regulation**

The second set of rules regulates mergers and takeovers from a competition policy perspective. Mergers and takeovers are examined at European or national level before completion of the transaction with a view to protect undistorted competition on the internal EU market. The competent authority may either prohibit the merger or give a clearance to the transaction. Mergers/takeovers going beyond the national borders of a Member State are examined at European level. If the annual turnover of the combined businesses exceeds specified thresholds in terms of global and European sales, the proposed merger/takeover must be notified to the European Commission. Below these thresholds, national competition authorities review the proposed merger/takeover. The European merger policy is based on Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation).

Despite considerable achievements of the EU single market, at the turn of the century the EU economy has grown relatively slowly compared to the US which was mainly due to weaker labour productivity and lower employment rate. This has prompted a ten-year economic development programme (the so called **Lisbon reform**) at the beginning of the current decade. It aimed at improving the competitiveness of the European economy, boosting economic growth and creating more jobs.

The development of **an active market in corporate control in the EU** was considered to be crucial in the light of the objectives of the Lisbon reform. With the exception of the UK, hostile takeovers were rare in the EU. For example, until the deal between Vodafone and

[5] Available at: http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/ce321/ce32120061229en00010331.pdf
[6] However, Articles 57, 59 and 60 foresee the possibility of specific restrictions, safeguard measures or sanctions in respect of third countries.
[7] The ECJ is the institution competent for interpreting the EC Treaty and its interpretations are binding on Member States.
[8] Available at: http://ec.europa.eu/internal_market/capital/framework/court_en.htm

Mannesmann in 1999, Germany had witnessed only a handful of attempted hostile deals, none of which succeeded[9]. The low incidence of hostile bids in Continental Europe could be explained primarily by structural barriers related to the way in which companies are owned and financed. Another important factor was the availability and use of a wide range of company law-related takeover barriers (takeover defences, see below)[10].

The development of an active takeover market was expected to effectively contribute to the competitiveness of European companies and the economy for the following reasons.

a) Acquisitions can be important **drivers of value creation**. Takeovers facilitate corporate restructuring and consolidation and provide a means for companies to achieve an optimal scale, a precondition for competing effectively on an integrated European market, as well as on the global market. They help in disseminating good management practices and technology and in exploiting synergies between the offeror and target company. They may improve the quality of management and ensure better corporate performance.

b) Takeovers **discipline management,** therefore an active corporate control market is considered to be an "external corporate governance mechanism" inducing companies to operate efficiently.

c) **Common takeover rules have been considered to be an important element of an integrated European capital market**. They were to ensure that takeovers are subject to the same company law related requirements throughout the EU. If takeovers are regulated in the same way in all Member States, they can take place and succeed with the same expectation of success and provide investors with a similar opportunity to tender their shares all over the EU.

It has been acknowledged that takeovers are not always beneficial for all (or indeed any) of the parties involved. However, the development of an active corporate control market has been regarded as being in the best interest of all stakeholders and companies.

2. Main policy considerations of takeover regulation in the European Union[11]

The main political objectives of the common EU takeover rules were the following**:**

a) Facilitation of takeovers

For the purpose of exploiting the benefits mentioned above, takeover regulation aimed at encouraging efficient corporate restructuring through

- eliminating certain takeover barriers,
- reducing the cost of control transfers, and
- raising the level of information on the market.

b) Protection of investors, including minority shareholders

[9] Jeremy Grant: takeovers and the market for corporate control
[10] See below
[11] Jeremy Grant: Takeover regulation and the balancing of interests, in European takeovers, the art of acquisition

The other principal policy objective of the takeover regulation was to protect investors through

- addressing information asymmetries between the bidder and the target firm and its shareholders via stringent disclosure requirements,
- introducing common rules to address asymmetries of bargaining powers and conflicts of interest in the context of a change of control via providing minority shareholders with a valuable opportunity to exit from the company on fair terms and
- providing an exit opportunity for minority shareholders on fair terms after the successful completion of the takeover.

It was crucial to find a **right balance between these objectives** as they may lead to conflicting results. For example, regulatory requirements which protect minority shareholders of the target company may increase the price of a bid for a potential acquirer by distributing more of the gains from the takeover to the target's shareholders. This could make some bids less attractive, thus discouraging value-increasing transactions. Overall, the aim was to facilitate entry for effective acquirers, provide a fair exit opportunity for minority investors and to ensure a high degree of legal certainty.

3. A short history of the Directive on takeover bids

The adoption of common European rules on takeover bids was on the agenda since 1985, however the final agreement was found only following a two decade-long struggle.

The objective of the common takeover rules has been to harmonise rules in EU Member States according to the policy objectives mentioned in section 2.

Harmonisation of national laws is promoted typically through the adoption of directives in the EU. Directives constitute an important bulk of EU legislation. They typically provide for rules which are binding on Member States, however Member States may determine the most appropriate way to align their national law with these rules.

The European Commission – the institution responsible for proposing EU legislation - first announced its intention to propose a Directive on the approximation of Member States' laws on takeover bids in its 1985 White Paper on completing the Internal Market. In 1989, the Commission presented to the Council and the European Parliament (the institutions responsible for adopting EU legislation on the basis of the proposal of the Commission) a proposal for a Directive[12]. The co-legislators found this proposal overly detailed and the Commission eventually decided to withdraw it.

The second proposal adopted in 1996[13] was drawn up in the form of a framework directive containing only general provisions governing takeovers bids, leaving much scope for Member States and for the national authorities competent in takeover matters to deal with the detailed implementation of those principles. The negotiation of this proposal lasted long. In the meantime, many Member States had already adopted national takeover legislation that was more ambitious than the provisions of the Directive and these rules have been successfully tested in the largest hostile deals in European history at that time[14].

[12] This proposal was subsequently amended in 1990.
[13] Modified in 1997
[14] E.g. hostile bid of Olivetti for Telecom Italia in 1998/99.

The second proposal was finally rejected in 2001 by the European Parliament on the grounds that the proposal failed to provide a level playing field throughout the EU as regards contestability of control of companies[15].

As referred to above, in the context of the Lisbon reform the adoption of the Takeover Directive has become a priority. Right after the rejection of the second proposal, the Commission decided to set up a High Level Group of Company Law Experts which was given a mandate to look at ways and means to modernise European company law. The mandate of the Group specifically included the examination of the issues raised by the Parliament in relation to takeover bids. The High level group delivered its report in January 2002 which formed the basis of the last Commission proposal issued in October 2002 and adopted by the Council and the European Parliament in 2004[16].

4. The main provisions of the Directive

The Directive lays down measures relating to takeover bids for the securities of companies governed by the laws of Member States, where all or some of those securities are admitted to trading on the stock exchange or other regulated market.

Member States were to transpose the provisions of the Directive into national law by April 2006. The Directive has already been transposed in the large majority of Member States.

The Directive sets out framework provisions and Member States are allowed to provide for further, more stringent rules than those of the Directive in case they deem it necessary and these additional rules aim at ensuring compliance with the main principles of the Directive, which are the following (Article 3):

General principles

1. For the purpose of implementing this Directive, Member States shall ensure that the following principles are complied with:

(a) all holders of the securities of an offeree company of the same class must be afforded equivalent treatment; moreover, if a person acquires control of a company, the other holders of securities must be protected;

(b) the holders of the securities of an offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid; where it advises the holders of securities, the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company's places of business;

[15] The proposal have not dealt with all the main takeover defences but with so called post-bid defences only (see below) although there have been significant differences as regards available takeover defensive mechanisms across the EU. Making the use of post-bid defences more difficult would have made the companies of certain Member States more vulnerable to takeovers than others.

[16] The report is available at http://ec.europa.eu/internal_market/company/docs/takeoverbids/2002-01-hlg-report_en.pdf. This paper contains direct citations from this report.

(c) the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid;

(d) false markets must not be created in the securities of the offeree company, of the offeror company or of any other company concerned by the bid in such a way that the rise or fall of the prices of the securities becomes artificial and the normal functioning of the markets is distorted;

(e) an offeror must announce a bid only after ensuring that he/she can fulfil in full any cash consideration, if such is offered, and after taking all reasonable measures to secure the implementation of any other type of consideration;

(f) an offeree company must not be hindered in the conduct of its affairs for longer than is reasonable by a bid for its securities.

The first principle regarding equal treatment of shareholders is particularly important. It ensures that a bidder cannot discriminate between shareholders of the same class as regards the consideration offered in the bid. It also underpins the mandatory bid provision (see below).

1) Provisions aiming at eliminating company law-related takeover barriers

As explained above, the low incidence of hostile bids in Continental Europe were partly due to concentration of shareholdings and the use of takeover defence mechanisms.

a) Models of corporate control in Europe

Shareholdings in Continental Europe **are** much more **concentrated** than in the UK or US, with families often retaining control of firms after they have been taken public[17].

For example in 52% of the top 100 French firms either one shareholder or a shareholder group controlled over 50% of the votes at the annual general meeting in 2004. This number was even higher in Germany (55%) and Italy (70%)[18]. Empirically most companies in Europe have a blockholder commanding at least a blocking minority of 25% of the voting rights[19].

Control by large shareholders or shareholder blocks in Continental Europe can be enhanced via **devices that** distort the distribution of voting rights and hence **provide for a disproportionate control power** compared to the risk and cash flow rights in the company. Prominent examples are equity capitalisations with shares with multiple voting rights and issuance of certificates without votes.

Control enhancing mechanisms can also be used in widely held companies where no single shareholder or tied group of shareholders can control the company. Such defences include voting right restrictions, share transfer restrictions and shares vested with special rights.

b) Takeover defences

[17] Jeremy Grant: takeovers and the market for corporate control
[18] Grant and Kirchmaier (2004).
[19] Marco Becht: Reciprocity in Corporate Takeovers

Takeover defences may prevent change of control over companies or make a takeover more difficult or costly. As a consequence, they entrench management and/or certain incumbent shareholders and render companies immune to unfriendly raiders.

There are two categories of defensive mechanisms:

- -"**Post-bid defences**" are put in place once the company has become subject to a takeover bid. Such defences include share buybacks aimed at reducing the number of shares the bidder could acquire or the issue of share capital –so as to increase the cost of the bid.

These defences are generally put in place by the target company's management. The application of such post bid defences is subject to shareholder approval in a number of Member States or certain other limitations in others (see below).

- **-"Pre-bid defences"** are generally provided for in the company's articles of association or in agreements between shareholders. They typically enhance the voting power of certain shareholder(s) as referred to above (e.g. shares conferring multiple voting rights), prevent the acquisition of shares in the target company (e.g. share transfer restrictions) or create a barrier to the exercise of control in the target company (e.g. voting cap)[20].

There are significant differences in EU Member States as to which pre-bid defensive measures companies can apply[21].

c) The Directive's rules on takeover defences

The purpose of the directive in facilitating takeover activity required the **removal of some of the main takeover defences which could be applied by the management or which enhanced the control power of certain shareholders and did not allow takeovers to be undertaken on equal conditions in the different EU Member States.** The debate in the course of the negotiations on the various proposals for a Directive focused primarily on **what model Europe should adopt regarding takeover defences.**

As far as **post-bid defences** are concerned, the Directive has been largely inspired by the UK Takeover Code and requires shareholder decision making on such defenses (so called **board neutrality rule**).

[20] Some of these mechanisms create potential barriers to the acquisition of shares in the company (ownership caps, restrictions to the transferability of shares). The second category of mechanisms create barriers to the exertion of control in the general meeting, thus preventing a successful bidder to take the necessary measures to reorganize the company once the bid is successful. Such mechanisms include voting caps, shares with double or multiple voting rights, binding voting agreements; voting trusts, supermajority voting arrangements, etc. The third category comprises barriers to the exertion of control in the board of directors. These include e.g. shares with special rights to appoint directors, supermajority requirement to dismiss and/or elect the board. The last category comprises barriers to exertion of control over the assets of the company, such as lock-ups of corporate assets ("crown jewels").

[21] See in this respect the report on the proportionality principle in the European Union prepared by Sherman and Sterling, ISS and ECGI, published on: http://ec.europa.eu/internal_market/company/shareholders/indexb_en.htm

The aim of the board neutrality rule is twofold:

- it facilitates corporate restructuring through restricting the possibilities of the management to frustrate takeovers and
- it **addresses potential conflicts of interests between the management and shareholders**. Whilst a takeover bid may increase shareholder value, it is also likely to endanger the job of the management. Therefore they may be willing to launch defensive measure to the detriment of the interests of shareholders.

Article 9 of the Directive defines the board neutrality rule as follows:

Obligations of the board of the offeree company

1.Member States shall ensure that the rules laid down in paragraphs 2 to 5 are complied with.

2.During the period referred to in the second subparagraph, the board of the offeree company shall obtain the prior authorisation of the general meeting of shareholders given for this purpose before taking any action, other than seeking alternative bids, which may result in the frustration of the bid and in particular before issuing any shares which may result in a lasting impediment to the offeror's acquiring control of the offeree company.

Such authorisation shall be mandatory at least from the time the board of the offeree company receives the information referred to in the first sentence of Article 6(1) concerning the bid and until the result of the bid is made public or the bid lapses. Member States may require that such authorisation be obtained at an earlier stage, for example as soon as the board of the offeree company becomes aware that the bid is imminent.

3.As regards decisions taken before the beginning of the period referred to in the second subparagraph of paragraph 2 and not yet partly or fully implemented, the general meeting of shareholders shall approve or confirm any decision which does not form part of the normal course of the company's business and the implementation of which may result in the frustration of the bid.

4.For the purpose of obtaining the prior authorisation, approval or confirmation of the holders of securities referred to in paragraphs 2 and 3, Member States may adopt rules allowing a general meeting of shareholders to be called at short notice, provided that the meeting does not take place within two weeks of notification's being given.

5.The board of the offeree company shall draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business as set out in the offer document in accordance with Article 6(3)(i). The board of the offeree company shall at the same time communicate that opinion to the representatives of its employees or, where there are no such representatives, to the employees themselves. Where the board of the offeree company receives in good time a separate opinion from the representatives of its employees on the effects of the bid on employment, that opinion shall be appended to the document.

6.For the purposes of paragraph 2, where a company has a two-tier board structure «board» shall mean both the management board and the supervisory board.

The board neutrality rule is fully consistent with key features of European company law which provides for shareholder decision–making on important structural decisions. **Most Member States have already restricted the freedom of the management to engage in takeover-frustrating action before the adoption of the Directive.** Even in those Member States where the management is not bound by a full passivity obligation, there are strict limitations in place. For example, shareholders are to approve any increase of capital under the terms of Community rules in all Member States if the firm does not already have authorisation for issuing new share capital. Furthermore, other limitations are set at national level. For example in Germany, post-bid defences can be applied by the management board only with the consent of the supervisory board. Some of the possible post-bid defensive instruments require shareholder approval, such as share buy-backs and sale of major assets.

As regards **pre-bid defences**, the Directive introduces the so called **breakthrough rule** which aims at ensuring that **certain mechanisms enhancing the control power of certain shareholders do not frustrate or unduly inhibit takeover bids** or their successful execution. The rule aims at ensuring that

- restrictions that would prevent the bidder from acquiring shares during should not apply during the takeover period,
- certain control enhancing mechanisms should not apply at the general meeting of shareholder which decide on any post-bid defensive measure and
- certain control enhancing mechanisms should not prevent a bidder which has acquired a very substantial part of the risk-bearing capital in the target company from amending the company's charter and/or removing the incumbent management.

The breakthrough rule "breaks through" control enhancing mechanisms through the application of the principle of **proportionality between risk-bearing capital and control.**

The proportionality concept means that during the takeover bid **only the risk-bearing capital should normally carry control rights, in proportion to the risk carried.** Such shareholders are best equipped to decide on the affairs of the company as the ultimate effects of their decisions will be born by them. The holders of the majority of risk bearing capital should be able to exercise control[22].

Under the terms of the breakthrough rule the **proportionality principle should apply in both stages of the takeover process: once the bid is announced (1) and after the successful completion of the bid (2).**

> (1) In the first stage, disproportionate control rights can be used to authorise the board to frustrate the bid if the board or the minority shareholder controlling the board wishes to oppose it. Application of the proportionality principle once a takeover bid is announced means that an authorisation by the general meeting of shareholders to take actions frustrating the bid would only be valid if made by a majority of votes exercised by the holders of the proportionate majority of the risk-bearing capital of the company.
>
> (2) In the second stage, once a bidder has acquired 75% of the voting capital of the company the proportionality principle allows him to exercise the core control rights

[22] Report on issues related to takeover bids of the high level group of company law experts, Brussels, January 2OO2

that company law grants to shareholders and to reorganize the company including through changing the company's management.

Article 11of the Directive on the breakthrough rule provides the following:

Breakthrough

1.Without prejudice to other rights and obligations provided for in Community law for the companies referred to in Article 1(1), Member States shall ensure that the provisions laid down in paragraphs 2 to 7 apply when a bid has been made public.

2 .Any restrictions on the transfer of securities provided for in the articles of association of the offeree company shall not apply vis-à-vis the offeror during the time allowed for acceptance of the bid laid down in Article 7(1).

Any restrictions on the transfer of securities provided for in contractual agreements between the offeree company and holders of its securities, or in contractual agreements between holders of the offeree company's securities entered into after the adoption of this Directive, shall not apply vis-à-vis the offeror during the time allowed for acceptance of the bid laid down in Article 7(1).

3. Restrictions on voting rights provided for in the articles of association of the offeree company shall not have effect at the general meeting of shareholders which decides on any defensive measures in accordance with Article 9.

Restrictions on voting rights provided for in contractual agreements between the offeree company and holders of its securities, or in contractual agreements between holders of the offeree company's securities entered into after the adoption of this Directive, shall not have effect at the general meeting of shareholders which decides on any defensive measures in accordance with Article 9.

Multiple-vote securities shall carry only one vote each at the general meeting of shareholders which decides on any defensive measures in accordance with Article 9.

4.Where, following a bid, the offeror holds 75 % or more of the capital carrying voting rights, no restrictions on the transfer of securities or on voting rights referred to in paragraphs 2 and 3 nor any extraordinary rights of shareholders concerning the appointment or removal of board members provided for in the articles of association of the offeree company shall apply; multiple-vote securities shall carry only one vote each at the first general meeting of shareholders following closure of the bid, called by the offeror in order to amend the articles of association or to remove or appoint board members.

To that end, the offeror shall have the right to convene a general meeting of shareholders at short notice, provided that the meeting does not take place within two weeks of notification.

5. Where rights are removed on the basis of paragraphs 2, 3, or 4 and/or Article 12, equitable compensation shall be provided for any loss suffered by the holders of those rights. The terms for determining such compensation and the arrangements for its payment shall be set by Member States.

6. Paragraphs 3 and 4 shall not apply to securities where the restrictions on voting rights are compensated for by specific pecuniary advantages.

7.This Article shall not apply either where Member States hold securities in the offeree company which confer special rights on the Member States which are compatible with the

Treaty, or to special rights provided for in national law which are compatible with the Treaty or to cooperatives.

It should be noted that a number of Member States have already eliminated certain pre-bid defenses such as multiple-vote securities, therefore the companies of these countries are more open to takeovers. Despite the availability of these defensive measures the companies in some Member States do not apply them in practice[23].

d) Optional arrangements

As a result of the final compromise which led to the adoption of the Directive, both the board neutrality and the breakthrough rule have been made optional for Member States.

Clear signs have indicated that market forces had been able to successfully eliminate certain takeover defensive measures in Europe (e.g. multiple vote securities). It was agreed that as a first step, it should be left to the pressure of the market to induce companies to dismantle control enhancing mechanisms. Instead of requiring Member States to impose the board neutrality and breakthrough rules, they should be required to decide whether or not they intend to make these rules mandatory at national level or allow their companies to apply these rules on a voluntary basis. If the market would not prove to be efficient enough to create favorable conditions to takeovers, the Directive should be revised 5 years after its entry into force.

Furthermore a reciprocity provision has been introduced which provides for "equality of arms" in the optional system: if a company which applies the rules of the Directive (non-protected company) becomes subject to a takeover bid launched by a company not applying the same rules (protected company), the target does not need to apply the Directives' rules on takeover defenses. However, the application of the reciprocity provision is subject to strict conditions, i.e. the law of the relevant Member State should allow companies to use reciprocity and the general meeting should give regular prior authorization.

Article 12 of the Directive on the optional arrangements reads as follows:

Optional arrangements

1.Member States may reserve the right not to require companies as referred to in Article 1(1) which have their registered offices within their territories to apply Article 9(2) and (3) and/or Article 11.

2.Where Member States make use of the option provided for in paragraph 1, they shall nevertheless grant companies which have their registered offices within their territories the option, which shall be reversible, of applying Article 9(2) and (3) and/or Article 11, without prejudice to Article 11(7).

The decision of the company shall be taken by the general meeting of shareholders, in accordance with the law of the Member State in which the company has its registered office in accordance with the rules applicable to amendment of the articles of association. The

[23] See in this respect the report on the proportionality principle in the European Union prepared by Sherman and Sterling, ISS and ECGI, published on: http://ec.europa.eu/internal_market/company/shareholders/indexb_en.htm

decision shall be communicated to the supervisory authority of the Member State in which the company has its registered office and to all the supervisory authorities of Member States in which its securities are admitted to trading on regulated markets or where such admission has been requested.

3.Member States may, under the conditions determined by national law, exempt companies which apply Article 9(2) and (3) and/or Article 11 from applying Article 9(2) and (3) and/or Article 11 if they become the subject of an offer launched by a company which does not apply the same Articles as they do, or by a company controlled, directly or indirectly, by the latter, pursuant to Article 1 of Directive 83/349/EEC.

4.Member States shall ensure that the provisions applicable to the respective companies are disclosed without delay.

5.Any measure applied in accordance with paragraph 3 shall be subject to the authorisation of the general meeting of shareholders of the offeree company, which must be granted no earlier than 18 months before the bid was made public in accordance with Article 6(1).

2) Provisions aiming at protecting minority shareholders in case of acquisition of a controlling stake and related rights

a) Mandatory bid and equitable price

As referred to above, one of the main objectives of the Directive is to protect investors, including minority shareholders. The most important rule aiming at protecting minority shareholders is the mandatory bid provision which obliges a person who acquires control in a company to make a bid for all the remaining securities at an equitable price. The control threshold is not defined in the Directive, thus Member States are free to set the appropriate threshold at national level. Most Member States fix this threshold at 30 or 33% of the voting rights. The equitable price to be offered in the mandatory bid is, in normal circumstances, equal to the highest price paid by the offeror for shares in that class, whether on or off the market, during a certain period preceding the date of the acquisition of securities by the offeror, which resulted in the change in the control of the company. Member States are free to set the length of this period between 6 and 12 months[24].

The policy considerations of the mandatory bid rule are the following:

- following a change of control, minority shareholders can be caught up in the company with an unknown controlling shareholder who may want to take decisions or extract private benefits of control at the expense of minority shareholders. The mandatory bid rule provides minority shareholders with a **right to exit from the company** in such cases.

[24] The Directive provides for flexibility in case the highest price rule would not represent adequately the value of the target company's shares. This may be the case for example if the highest price paid was set by collusion (i.e. an agreement with the vendor aimed at evading the highest price paid rule), market prices in general have been affected by highly exceptional events or market prices for the relevant securities have been manipulated. Supervisory authorities are allowed to set a price different from the price determined in the Directive under such circumstances.

- The **equitable price** ensures that **shareholders are not pressured to tender their shares on unfair terms in case of control change**. The equitable price rule ensures that **all shareholders are treated equally** and minority shareholder also benefit from the premium paid for the controlling stake in the company. Furthermore it also gives the offeror the certainty that he will not have to pay more in the mandatory bid than he has been willing to pay in the preceding period and as a result permitting him to determine himself at which maximum price he is prepared to acquire all securities of the company.

- This rule also prohibits the sale of control blocks and thus **prevents the controlling shareholder from extracting private control benefits ex post a takeover**.

The mandatory bid provision (Article 5) of the Directive is as follows:

Protection of minority shareholders, the mandatory bid and the equitable price

1.Where a natural or legal person, as a result of his/her own acquisition or the acquisition by persons acting in concert with him/her, holds securities of a company as referred to in Article 1(1) which, added to any existing holdings of those securities of his/hers and the holdings of those securities of persons acting in concert with him/her, directly or indirectly give him/her a specified percentage of voting rights in that company, giving him/her control of that company, Member States shall ensure that such a person is required to make a bid as a means of protecting the minority shareholders of that company. Such a bid shall be addressed at the earliest opportunity to all the holders of those securities for all their holdings at the equitable price as defined in paragraph 4.

2. Where control has been acquired following a voluntary bid made in accordance with this Directive to all the holders of securities for all their holdings, the obligation laid down in paragraph 1 to launch a bid shall no longer apply.

3. The percentage of voting rights which confers control for the purposes of paragraph 1 and the method of its calculation shall be determined by the rules of the Member State in which the company has its registered office.

4.The highest price paid for the same securities by the offeror, or by persons acting in concert with him/her, over a period, to be determined by Member States, of not less than six months and not more than 12 before the bid referred to in paragraph 1 shall be regarded as the equitable price. If, after the bid has been made public and before the offer closes for acceptance, the offeror or any person acting in concert with him/her purchases securities at a price higher than the offer price, the offeror shall increase his/her offer so that it is not less than the highest price paid for the securities so acquired.

Provided that the general principles laid down in Article 3(1) are respected, Member States may authorize their supervisory authorities to adjust the price referred to in the first subparagraph in circumstances and in accordance with criteria that are clearly determined. To that end, they may draw up a list of circumstances in which the highest price may be adjusted either upwards or downwards, for example where the highest price was set by agreement between the purchaser and a seller, where the market prices of the securities in question have been manipulated, where market prices in general or certain market prices in particular have been affected by exceptional occurrences, or in order to enable a firm in

difficulty to be rescued. They may also determine the criteria to be applied in such cases, for example the average market value over a particular period, the break-up value of the company or other objective valuation criteria generally used in financial analysis.

Any decision by a supervisory authority to adjust the equitable price shall be substantiated and made public.

5. By way of consideration the offeror may offer securities, cash or a combination of both.

However, where the consideration offered by the offeror does not consist of liquid securities admitted to trading on a regulated market, it shall include a cash alternative.

In any event, the offeror shall offer a cash consideration at least as an alternative where he/she or persons acting in concert with him/her, over a period beginning at the same time as the period determined by the Member State in accordance with paragraph 4 and ending when the offer closes for acceptance, has purchased for cash securities carrying 5 % or more of the voting rights in the offeree company.

Member States may provide that a cash consideration must be offered, at least as an alternative, in all cases.

6. In addition to the protection provided for in paragraph 1, Member States may provide for further instruments intended to protect the interests of the holders of securities in so far as those instruments do not hinder the normal course of a bid.

b) Squeeze-out right

The squeeze-out right of the Directive refers to **the right of a majority shareholder in a company to compel the minority shareholders to sell their shares to him**. The majority shareholder enjoys this right only if he has acquired a very substantial part of the shares of the company following a takeover bid, i.e.

(a) where the offeror holds securities representing not less than **90 % of the capital carrying voting rights and 90 % of the voting rights** in the offeree company, or

(b) where, following acceptance of the bid, he/she has acquired or has firmly contracted to acquire securities representing not less than 90 % of the offeree company's capital carrying voting rights and 90 % of the voting rights comprised in the bid.

The directive provides that in the case referred to in (a), **Member States may set a higher threshold that may not, however, be higher than 95 % of the capital carrying voting rights and 95 % of the voting rights**.

The main reasons for a squeeze-out mechanism are the following:

- This right **liberates the majority shareholder from costs and risks linked to the existence of minority shareholders**, such as

  (i) costs related to his inability fully to integrate the acquired company into his group in terms of activities, use of assets, organisation and finance. The continued existence of minority shareholders inhibits efficient management by

the majority shareholder of the company as a part of his group and thereby reduces the potential benefits of the takeover of the company;
(ii) the majority shareholder will incur direct costs for having to maintain the infrastructure for holding general meetings of shareholders;
(iii) the majority shareholder runs the risk of abusive exploitation by the minority shareholders of their rights. Minorities may threaten to use their rights only to inflict costs and disturbance on the majority shareholder in order to induce him to agree to their wishes or to obstruct his development of the company's business.

- The squeeze-out can also be viewed as a **compensating right for the burden laid on the controlling shareholder through the mandatory bid obligation** and **makes takeover bids more attractive.**

As the squeeze-out right directly affects minorities' property rights, the conditions of such a provision had to be set in the light of the need to ensure an appropriate level of protection of these rights.

Property rights are guaranteed by the European Convention on Human Rights, and the protection offered by these provisions makes it possible to deprive a person of his property only if this is justified by the public interest and if appropriate compensation is offered.

The Directive's squeeze-out complies with the requirements of the European Convention on Human Rights:

- As indicated above, the main justification of such a right is to have companies efficiently managed, and securities markets sufficiently liquid.

- The Directive ensures that the squeeze-out right applies only in highly exceptional circumstances, when a very high proportion of the voting capital and voting rights has been acquired.
- Furthermore the Directive provides for an equitable compensation for the squeezed-out minority. A fair price should be guaranteed for the remaining shares. Following a voluntary bid, the consideration offered in the bid shall be presumed to be fair where, through acceptance of the bid, the offeror has acquired securities representing not less than 90% of the capital carrying voting rights comprised in the bid. Following a mandatory bid, the consideration offered in the bid shall be presumed to be fair. The faire price therefore allows the squeezed-out minority to benefit from the control premium.

Squeeze-out is regulated in Article 15 of the Directive:

The right of squeeze-out

1. Member States shall ensure that, following a bid made to all the holders of the offeree company's securities for all of their securities, paragraphs 2 to 5 apply.

2. Member States shall ensure that an offeror is able to require all the holders of the remaining securities to sell him/her those securities at a fair price. Member States shall introduce that right in one of the following situations:

(a) where the offeror holds securities representing not less than 90 % of the capital carrying voting rights and 90 % of the voting rights in the offeree company,

or

(b) where, following acceptance of the bid, he/she has acquired or has firmly contracted to acquire securities representing not less than 90 % of the offeree company's capital carrying voting rights and 90 % of the voting rights comprised in the bid.

In the case referred to in (a), Member States may set a higher threshold that may not, however, be higher than 95 % of the capital carrying voting rights and 95 % of the voting rights.

3.Member States shall ensure that rules are in force that make it possible to calculate when the threshold is reached.

Where the offeree company has issued more than one class of securities, Member States may provide that the right of squeeze-out can be exercised only in the class in which the threshold laid down in paragraph 2 has been reached.

4. If the offeror wishes to exercise the right of squeeze-out he/she shall do so within three months of the end of the time allowed for acceptance of the bid referred to in Article 7.

5. Member States shall ensure that a fair price is guaranteed. That price shall take the same form as the consideration offered in the bid or shall be in cash. Member States may provide that cash shall be offered at least as an alternative.

Following a voluntary bid, in both of the cases referred to in paragraph 2(a) and (b), the consideration offered in the bid shall be presumed to be fair where, through acceptance of the bid, the offeror has acquired securities representing not less than 90 % of the capital carrying voting rights comprised in the bid.

Following a mandatory bid, the consideration offered in the bid shall be presumed to be fair.

c) Sell-out right

The sell-out right refers to the right of a minority shareholder to compel the majority shareholder to purchase his shares from him. It thus constitutes a mirroring right to the squeeze-out rule for minority shareholders. Similarly to the right to squeeze-out, the Directive requires the majority shareholder to pay a fair price for the remaining shares. The fair price is defined in a similar way as in the squeeze-out rule.

The justifications for the sell-out right are the following:

- after a takeover bid, the majority shareholder may be tempted to abuse his dominant position, e.g. by causing the company to enter into transactions with related parties, through changes in the dividend policy, by changing the strategy of the company to fit the objectives of the wider group of companies controlled by the acquiring company, by reducing the information provided to minority shareholders, etc.

- in situations where the market has become illiquid as a result of the takeover bid, minority shareholders cannot obtain appropriate compensation by simply selling their shares in the market;

- the sell-out right is an appropriate mechanism to counter the pressure on shareholders to tender in the takeover bid.

The right of sell-out

1.Member States shall ensure that, following a bid made to all the holders of the offeree company's securities for all of their securities, paragraphs 2 and 3 apply.

2.Member States shall ensure that a holder of remaining securities is able to require the offeror to buy his/her securities from him/her at a fair price under the same circumstances as provided for in Article 15(2).

3.Article 15(3) to (5) shall apply mutatis mutandis .

3) Disclosure requirements

a) Transparency regarding takeover defences

One of the most important provisions of the Directive requires full disclosure of capital structures and measures which may affect the outcome of a potential takeover bid on the company (Article 10):

This provision is particularly important as better transparency on takeover defences may, in itself, significantly contribute to facilitating takeovers. Regular reporting by companies on available takeover defences will shed light on the contestability of their control and will likely become an important element that determines investment decisions and thus the cost of capital. It is likely that better transparency will induce companies to further dismantle takeover defences.

Information on listed companies

1.Member States shall ensure that companies as referred to in Article 1(1) publish detailed information on the following:

(a) the structure of their capital, including securities which are not admitted to trading on a regulated market in a Member State, where appropriate with an indication of the different classes of shares and, for each class of shares, the rights and obligations attaching to it and the percentage of total share capital that it represents;

(b) any restrictions on the transfer of securities, such as limitations on the holding of securities or the need to obtain the approval of the company or other holders of securities,

(c) significant direct and indirect shareholdings (including indirect shareholdings through pyramid structures and cross-shareholdings;

(d) the holders of any securities with special control rights and a description of those rights;

(e) the system of control of any employee share scheme where the control rights are not exercised directly by the employees;

(f) any restrictions on voting rights, such as limitations of the voting rights of holders of a given percentage or number of votes, deadlines for exercising voting rights, or systems whereby, with the company's cooperation, the financial rights attaching to securities are separated from the holding of securities;

(g) any agreements between shareholders which are known to the company and may result in restrictions on the transfer of securities and/or voting rights;

(h) the rules governing the appointment and replacement of board members and the amendment of the articles of association;

(i) the powers of board members, and in particular the power to issue or buy back shares;

(j) any significant agreements to which the company is a party and which take effect, alter or terminate upon a change of control of the company following a takeover bid, and the effects thereof, except where their nature is such that their disclosure would be seriously prejudicial to the company; this exception shall not apply where the company is specifically obliged to disclose such information on the basis of other legal requirements;

(k) any agreements between the company and its board members or employees providing for compensation if they resign or are made redundant without valid reason or if their employment ceases because of a takeover bid.

2.The information referred to in paragraph 1 shall be published in the company's annual report.(…).

3.Member States shall ensure, in the case of companies the securities of which are admitted to trading on a regulated market in a Member State, that the board presents an explanatory report to the annual general meeting of shareholders on the matters referred to in paragraph 1.

b) Provisions regulating the takeover process, information on the bid

The Directive lays down a number of provisions requiring the offeror to provide all the necessary information to the market which will allow target shareholders to make an appropriate decision on the merits of the bid. The Directive[25] provides that a decision to make a bid is to be made public without delay and that the supervisory authority is to be informed of it. Furthermore, the offeror is required to draw up and make public in good time an offer document containing the information necessary to enable the holders of the offeree company's securities to reach a properly informed decision on the bid[26].

[25] Article 6

[26] The minimum content of the offer document is set out in Article 6 (3). Article 7 provides that Member States should set the time period allowed for acceptance between two and ten weeks from the publication of the offer document.

Conclusion

As the Directive has only recently been transposed into Member States' legislation, its provisions have been applied only in a limited number of cases. However, some of its main provisions can be considered as a **major step forward to promote fair and transparent markets**.

The mandatory bid rule has been introduced in some countries for the first time and it has greatly raised the level of minority protection in Europe.

The squeeze-out mechanism is likely to make takeovers more attractive and will facilitate such transactions within the EU. The sell out-right has improved the protection of minority shareholders.

As regards the provisions of the Directive related to takeover defenses, **a large majority of Member States (72%) impose the application of the board neutrality rule**[27]. Therefore the management of 75% of European listed companies will not be able to take action which may result in the frustration of a takeover bid without the approval of shareholders. As referred to above, even in those Member states where there is no strict board neutrality obligation, the management's room of manoeuvre is generally greatly restricted. The Directive has contributed to extend or clarify the board neutrality obligation in a number of Member States. A few Member States have, however, introduced the reciprocity exception to provide a level playing field. The European corporate control market can therefore be considered as open from the perspective of the managements' frustrating powers.

The breakthrough provision has been imposed at legislative level in a few Member States only. However, the breakthrough rule has been partially imposed in a number of member states (e.g. France, Italy and Portugal) and companies in all Member States can now freely apply it on a voluntary basis if they wish so. Investors can put pressure on companies to follow the rule. It is an experiment that is about to begin whether the market will efficiently induce companies to lift the application of pre-bid defences in the context of takeover bids. Better transparency on defensive measures is expected to greatly contribute to such developments.

[27] Romania and Bulgaria are not covered.

Regulation of takeover bids in the European Union

KDI Conference on market for Corporate Control: comparative perspectives

Seoul, August 2007

European Commission
Internal Market & Services DG

1

Outline

1. Economic construction of the European Union, the economic context of the adoption of common EU rules on takeover bids
2. Main policy considerations of takeover regulation in the EU
3. The main provisions of the EU Directive on takeover bids
4. Likely effects of the new rules

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2

Economic construction of the EU

Based on 3 pillars:

- Single market

  -designed to improve the efficiency of the European economy

- European Monetary Union

  - to ensure monetary stability

- Community budget

  - to foster cohesion between EU Member States

Economic context of the adoption of common EU rules on takeover bids

- Promotion of a European market for corporate control has been on the agenda since 1985
- Became a priority at the turn of the century as part of a 10 year economic reform program
- Expected benefits:

  - facilitation of corporate restructuring and consolidation, value creation through exploiting synergies, dissemination good management practices, technology

  - disciplining management and majority shareholder

  - integration of EU capital markets

Main policy considerations of takeover regulation in the EU

- Facilitation of takeovers
  - eliminating certain takeover barriers,
  - reducing the cost of control transfers, and
  - raising the level of information on the market
- Protection of shareholders, including minorities
  - addressing information asymmetries between bidder and target shareholders via stringent disclosure requirements,
  - addressing asymmetries of bargaining powers and conflicts of interest in the context of change of control via providing minority shareholders with an exit opportunity on fair terms
  - providing an exit opportunity for minority shareholders on fair terms after the successful completion of the takeover

Directive 2004/25 on takeover bids

- Adopted in 2004
- « Directive »:

  - to be implemented into the laws of member states, effective as from April 2006
  - framework rules, member states' laws provide for details
- Implementation completed in the majority of member states
- Commission has published a report on the implementation early 2007

Main provisions of the Directive

Takeover facilitating rules:

- Rules aiming at lifting takeover barriers: board neutrality, breakthrough
- Transparency on takeover defences
- Squeeze-out of 10% minority

Rules on shareholder protection:

- Mandatory bid
- Sell-out right of 10% minority
- Disclosure on the bid

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7

Rules aiming at lifting takeover barriers (1)

- Models of corporate control in Europe:
  - shareholdings in continental Europe are concentrated as opposed to the UK or US
  - most European companies have a blockholder of 25% of the voting rights
- Availability of control enhancing mechanisms providing disproportionate control rights (e.g. shares with multiple voting rights) including mechanisms to lock-in control (veto rights, special appointment rights re management, voting caps, share-transfer restrictions)

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8

Rules aiming at lifting takeover barriers (2)

- Takeover defences: used by companies to prevent change of control

2 types:

- post-bid: applied by management to frustrate the bid (e.g. sell of « crown jewels »)
- pre-bid: control enhancing mechanisms provided in the companies articles of association and in shareholders agreements

- Directive aims at restricting the application of both categories of the defences

Rules aiming at lifting takeover barriers (3)

1. Board neutrality rule

- requires prior shareholder approval before the management takes any action which may result in the frustration of the bid
- targets post-bid defensive measures

2. Breakthrough

- Makes control enhancing mechanisms inapplicable (« breaks-through ») during the bid, at the shareholders' meeting deciding on frustrating action and once the bidder has acquired 75% of the voting capital
- Allows the bidder to exercise a control power proportionate to its shareholding and to remove the board and amend the articles of association

Rules aiming at lifting takeover barriers (4)

Optional arrangements

- Both the board neutrality and the breakthrough rule are optional for member states
- If a Member state decides not to impose them at national level, companies should be allowed to apply the rules voluntarily

Implementation at national level:

- a large majority of member states impose the board neutrality rule
- a few member states impose the breakthrough rule

Squeeze-out

- right of the majority shareholder to buy-out minority shareholders
  - after a successful bid
  - if the bidder owns 90-95% of the voting capital and voting rights
  - if the bidder provides a fair price
- liberates the majority shareholder from costs and risks linked to the existence of minority shareholders

Disclosure on takeover defences

- Obligation for listed companies to publish information on the structure of their capital and takeover defences, including
  - significant direct and indirect shareholdings (including through pyramid structures, cross-shareholdings)
  - control enhancing mechanisms,
  - the powers of the board (e.g. to issue or buy back shares)
  - significant agreements which take effect following a takeover bid, etc.

Protection of minority shareholders: mandatory bid

- obliges a person who acquires control in a company to make a bid for all the remaining securities at an equitable price

  - control threshold is set generally at 30-33%
  - equitable price is defined as the highest price paid by the offeror during a certain period prior to the bid
  - this rule gives an exit right for minority shareholders in case of change of control

Protection of minority shareholders: sell-out

- Right of minority shareholders to oblige the majority holder to buy their shares on a fair price
  - mirroring right to squeeze-out
  - if the bidder owns 90-95% of the voting capital and voting rights
  - same price as in squeeze-out
- Protects minorities from abuse of dominant position of the majority shareholder
- Appropriate compensation even in a situation where the market has become illiquid

Conclusions

- Too early to assess the effects of the Directive, however some of its provisions can be considered as a major step forward to promote fair and transparent markets
- Facilitation of takeovers:
  - the takeover market in some member states has already been open before the adoption of the Directive, the Directive will greatly contribute to this objective in some others
  - It remains to be seen whether the market will be efficient to force companies to apply the breakthrough voluntarily
- Protection of minority shareholders:
  - the mandatory bid and sell out provisions have greatly raised the level of minority protection in the EU