

Corporate Governance Convergence: Evidence From Takeover Regulation Reforms in Europe

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Abstract:

This paper contributes to the research on corporate governance by predicting the effects of European takeover regulation. In particular, we investigate whether the recent reforms of takeover regulation in Europe are leading to a harmonization of the national legislations. With the help of 150 corporate governance lawyers from 30 European countries, we collected the main changes in takeover regulation. We assess whether a process of convergence towards the Anglo-(American) corporate governance system has been started and we find that this is the case. We make predictions as to the consequences of the reforms for ownership and control. However, we find that, while in some countries the adoption of a unified takeover code may result in dispersed ownership, in others it may further consolidate the blockholder-based system.

JEL codes: G3, G34, G38, K2, K22, K40, G32

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1. Introduction

There are two polar systems of corporate governance: the market-based system and the blockholder-based system. The former prevails in the UK, US and the Commonwealth countries, and relies on legal rules largely resulting from case law and on the effective legal enforcement of shareholder rights. The blockholder-based system of Continental Europe relies on codified law and emphasizes rules protecting stakeholders such as creditors and employees. The two systems differ not only in terms of the rationale behind their legal rules, but also in terms of their ownership and control. Most Continental European companies are characterized by majority or near-majority stakes held by one or few investors. In contrast, the Anglo-American system is characterized by dispersed equity. The increasing economic globalisation has fuelled the debate on the best corporate governance system and the barriers to the development of a single system of corporate governance (see e.g. McCahery et al., 2002).

Although the debate has generated an extensive body of theoretical and empirical work, the conclusions remain opaque. There is yet no consensus as to what system of corporate law is the best one and whether legal convergence should be encouraged on a global level. A number of theoretical studies argue that regulatory and institutional convergence of corporate governance practice worldwide is likely, but the studies are in disagreement as to the direction of the convergence. In particular, will the Anglo-American model dominate or will a new hybrid model emerge? This paper comes up with some predictions as to the evolution of corporate governance that is likely to occur through the ongoing reforms of takeover regulation in Europe.

Takeover regulation constitutes an important element of corporate governance. Not only do changes in takeover regulation affect the level of investor protection, the development of capital markets and the market for corporate control, but they are also likely to cause changes in ownership and control. As such, reforms of takeover regulation constitute an important channel through which a corporate governance system can evolve. The paper provides a detailed assessment of established and newly introduced takeover rules. We identify and describe the main provisions in takeover regulation in 30 European countries and analyze how takeover regulation has changed in these countries over the past 15 years. About 150 legal experts throughout Europe have contributed to our unique and large database on the changes in corporate governance regulation (see the data appendix). We make predictions as to the consequences of the reforms of takeover regulation in terms of ownership and control.

Overall, this paper shows that there is convergence of European takeover regulation towards the UK regime. For example, the European countries have agreed that the equal treatment rule constitutes a fundamental principle of corporate law. There is also gradual convergence towards the adoption of the mandatory bid and squeeze-out rules. The introduction of lower

disclosure thresholds for control as well as the abolishment of shares with multiple voting rights, while still allowing for the use of non-voting shares, may also suggest that there is convergence towards the Anglo-American governance system. However, regulatory changes, which may at first sight appear similar across countries, may have totally different effects within their national system. While in some countries the adoption of a unified takeover code may disperse ownership, in others it may further concentrate ownership. We also conclude that, although the shareholder-centred view of corporate governance is receiving widespread recognition, some economies seem to opt for the blockholder-based system.

The paper is organized as follows. Section 2 discusses whether there is an optimal corporate governance system and whether the different national systems are likely to converge towards it. Section 3 reviews the corporate governance functions of takeover regulation, while section 4 predicts the impact of takeover regulation on the evolution of corporate governance. Section 5 assesses the possible regulatory mechanisms and their impact on the development of a well-functioning M&A market, on the improvement of shareholder protection, and on the evolution of ownership and control. Using a unique database on corporate law reforms in 30 European countries, section 6 documents the dynamics of takeover regulation and predicts the consequences of the reforms for the development of corporate governance systems. Section 7 concludes.

2. The evolution of corporate governance regulation: the convergence debate

The increasing economic globalisation has fuelled vivid debates on the similarities of and differences between national corporate governance systems and the barriers to the development of a single system of corporate governance (see e.g. McCahery et al. 2002). The key questions are whether a particular national corporate governance system has a competitive advantage over all other systems, and if yes, whether other systems ought to move towards it. These are important questions as the choice of corporate governance regime has an impact on the availability and cost of capital, corporate performance and the distribution of corporate value in a country.¹

Although there is now an extensive body of studies, their conclusions remain opaque. There is as yet no consensus as to the best system of corporate law and whether legal convergence should be encouraged on a global level. Some law and economics academics proclaim the superiority of the shareholder-oriented corporate governance system, characterized by well-developed capital markets, the prevalence of institutional investors, good investor protection, a

¹ The empirical literature documents that weak corporate governance, combined with weak enforcement of the law, distorts the efficient allocation of resources, undermines the ability of companies to compete internationally, and hinders investment and economic development.

market for corporate control, and a focus on shareholder value. La Porta et al. (1997) argue that this system, which exists predominantly in countries with a common law system, ensures a higher willingness of investors to provide financing as it aims at guaranteeing shareholders a fair return on their investment. In turn, this results in higher company valuations and growth potential (e.g. La Porta et al. (2002), Himmelberg et al. (2002)) and more developed and efficient financial markets (e.g. La Porta et al. (1997) and Mork et al. (2000)). Similarly, Levine (1998, 1999) shows that countries with English legal origin have better prospects in terms of long-run economic growth.

Despite the widely-held view on the superiority of the Anglo-American system, there are also supporters of the alternative systems such as the labour-oriented, state-oriented, and other stakeholder-oriented systems, prevailing in countries of German, French, Scandinavian, and Asian legal origin. The supporters of these alternative systems argue that the chief advantage of these systems lies in the way they address the misalignment of interests between managers and shareholders. Whereas in common law countries this problem is resolved via the monitoring by the market for corporate control and regulation forcing managers to follow the interests of the shareholders, civil law countries mainly rely on large shareholder, creditor or employee monitoring.

Given that the long-term interests of shareholders and stakeholders are not necessarily at odds, it is reasonable to expect the two monitoring mechanisms to produce similar outcomes in terms of long-term wealth creation. In line with this argument, the empirical literature² provides mixed evidence about the relative merits of the two mechanisms, but still suggests that the alternative systems of corporate governance can be as efficient as the ‘superior’ Anglo-American system. The lack of consensus regarding the optimal system of corporate governance has implications for the current law reforms. It raises the question as to the direction reformers of national systems should adopt.

Hansmann and Kraakman (2000) suggest that the increasing acceptance of a shareholder-centred ideology of corporate law by international business, governments, and legal elites will be translated into corporate law reforms and is likely to result in the convergence of corporate governance towards Anglo-American practice. An alternative view is based on the global competition hypothesis. It states that the two main competing systems should borrow the best practices from one another. This would result in a ‘hybrid model’ with the right mix of market discipline, corporate regulation, and power of corporate stakeholders. As an example of such a model one may think of the system proposed by the European Commission that is to provide firms with the freedom to select the model that best suits their needs (McCahery and Renneboog 2004). Bratton and McCahery (2000) have yet another view. They argue that each reform programme

² For a review of this literature see Becht, Bolton and Röell (2003), Dennis and McConnell (2003). For empirical evidence see Rajan and Zingales (1998), Carlin and Mayer (2003), Franks, Mayer and Renneboog (2001).

should focus on resolving the weaknesses of its national system, without attempting to change the system itself. This implies that worldwide convergence is not necessary.

Those predicting convergence of corporate governance regimes justify themselves by stating that convergence makes sense in terms of economic efficiency. However, others argue that economic efficiency may be an insufficient force to bring about convergence and that convergence may only be achieved if political and institutional barriers are eliminated. Thus, Roe (2002, 2003) and Coffee (2000) suggest that powerful interest and lobby groups are an important barrier to convergence. Roe (1991) claims that political constraints lead to a suboptimal system and prevent the move towards a more efficient system. Furthermore, Bebchuk and Roe (2000) stress the importance of path dependency in terms of the evolution of corporate governance. The initial institutional structures³ and their effect on the legal rules governing the corporations⁴ are two main factors that are likely to prevent convergence in practice.

Nonetheless, even if global convergence is unlikely to occur through changes in regulation or other institutional arrangements, Gilson (2000) suggests that there may be contractual convergence of best corporate practice. Firms may choose to deviate from the national corporate governance standards by opting into another corporate governance regime. This implies convergence at the company level rather than at the national (or federal state) level. The incidence of such contractual arrangements has significantly increased over the past decade via (i) cross-listings,⁵ (ii) a switch of the state of incorporation,⁶ and (iii) cross-border mergers and acquisitions.⁷ However, if contractual convergence were to take place, it would likely result in a ‘race-to-the-bottom’. Bebchuk and Cohen (2003) and Bebchuk and Ferrell (2001) show that the real reason to incorporate in another state is that companies are attracted to the states that provide managers with a wider range of anti-takeover measures. Hence, the competition between states to attract incorporations may actually worsen corporate governance. Similar trends may occur as a result of cross-border mergers and acquisitions. Companies from countries with less friendly takeover regimes are less likely to be taken over (and hence have more opportunities to seek target

³ As an example of initial structures Bebchuk and Roe (2000) mention ownership: the initial ownership affects ‘the identity of the corporate structure of the economy that would be efficient for any given company and, also, gives some parties both incentives and power to impede changes’.

⁴ The initial ownership affects both the type of corporate rules that will be efficient and the interest group politics (lobbying) that can determine which rules will actually be chosen.

⁵ Companies opting for an additional listing on another stock exchange have to adopt the listing requirements of that stock exchange, which may consist of different accounting standards, disclosure requirements, and governance structure (Karolyi (1997), Coffee (2002), Pagano, Röell and Zechner (2003), Licht (1998, 2003)).

⁶ Companies may incorporate in countries or states with favourable corporate governance rules. For example, in the US, Delaware accounts for almost 60% of all incorporations. According to Daines (2001), a switch to the Delaware incorporation has a positive impact on corporate value.

⁷ According to international law, when a foreign firm acquires 100% of a domestic firm, the nationality of the latter changes. Hence, the target firm usually adopts the accounting standards, disclosure practices, and governance structures of the acquiring firm (Bris and Cabolis (2002) and Rossi and Volpin (2003)).

companies abroad), whereas companies from countries with relatively friendly takeover regimes are more likely to become targets. Since the target usually adopts the acquirer's governance standards, the cross-border market for corporate control may evolve towards a less friendly takeover regime: either a blockholder-based regime or a market-based regime with effective takeover defences. In turn, this may push countries to adopt takeover regulation resulting in a less friendly takeover regime and hence in less efficient market monitoring of managers.

We conclude that the debate as to the worldwide convergence of corporate governance regimes is still ongoing. A growing number of studies predict global convergence of corporate governance regimes either via changes in the regulatory and institutional framework or via contractual arrangements. However, the predictions of these studies depart substantially from each other with respect to the motives for and the direction of convergence. While regulatory and institutional convergence may be driven by motives of economic efficiency, contractual convergence may be driven by other motives such as managerial entrenchment.

3. The corporate governance functions of takeover regulation

Although takeover regulation is mainly seen as a mechanism to facilitate efficient corporate restructuring (Burkart (1999)), it is also important in terms of mitigating conflicts of interests between diverse company constituencies such as management, shareholders, and stakeholders. Takeover regulation does not only curb conflicts of interests related to transfers of control, but also has a more general impact on the agency problems between management and shareholders, minority and majority investors, and other stakeholders. As such, it constitutes an important element of a corporate governance system. Its corporate governance role, however, depends on other characteristics of the governance system such as ownership and control (Goergen and Renneboog 2000, 2003).

In a system with dispersed ownership, the primary corporate governance role of takeover regulation is to restrain opportunistic managerial behaviour. Small shareholders cannot effectively monitor the management due to coordination problems and have to rely on external monitoring via the market for corporate control. Hostile takeovers target poorly performing firms and replace poorly performing management. The threat of losing their jobs and perquisites provides managers with an incentive to focus on shareholder objectives. The role of takeover regulation is then to design rules and provide instruments that minimize the costs and inefficiencies associated with the (hostile) takeover mechanism⁸ and thereby facilitate a transfer of control towards more productive

⁸ However, hostile takeovers may constitute a disruptive and costly mechanism to bring about a change in control as the vast majority of the takeovers does not yield the anticipated synergistic value increase (Gregory (1997), Dickerson, Gibson and Tsakalotos (1997), Rau and Vermaelen (1998), Ghosh (2001), Louis (2004)). There is no

owners and management. Examples of measures stimulating takeover activity are the squeeze-out rule, the break-through rule, and limitations to the use of takeover defence measures.

In a system with concentrated ownership, takeover regulation functions as a corporate governance device aiming at protecting minority shareholders' interests. The concentration of ownership and control is seen as an alternative mechanism that can mitigate the conflict of interests between management and shareholders. Major investors have strong incentives to monitor management and replace it in poorly performing companies (Franks, Mayer and Renneboog 2001). Bolton and von Thadden (1998) argue that the advantage of monitoring by blockholders is that it takes place on an ongoing basis. In contrast, external disciplining only occurs in crisis situations. However, the presence of a controlling shareholder is also associated with potential opportunistic behaviour towards minority shareholders. Although there are a number of standard company law techniques to resolve conflicts between the large shareholder and minority shareholders, takeover regulation plays an important role, as it can provide minority shareholders with an 'exit on fair terms' opportunity. Provisions such as the sell-out right, the mandatory bid rule, or the equal treatment principle, ensure such exit opportunities for minority shareholders.

Specific provisions of takeover regulation apply to control transactions to regulate conflicts of interests between the management and shareholders of the target and bidder. Two major agency problems may emerge. First, control transfers may turn the target's incumbent shareholders into minority shareholders. Second, the management of the target company may be tempted to implement unduly defence measures to obstruct the takeover, even if this clashes with shareholder interests. Takeover regulation should aim at minimizing both potential conflicts. In particular, a limit on the use of anti-takeover devices is seen as the best way to constrain opportunistic managerial behaviour. In addition, the mandatory bid rule and the sell-out right provide the target shareholders with a right to exit the company at a fair price.

Overall, the above discussion suggests that takeover regulation can have a number of provisions that perform corporate governance functions both in the case of a transfer of control and in terms of governance of ordinary corporate activity. There are, however, three important trade-offs. First, in countries with dispersed ownership, provisions aiming at providing an exit

evidence that hostile takeovers are able to create more (long-term) synergistic value than friendly ones and hostile acquisitions tend to be more disruptive than friendly ones. Therefore, even in the US and UK where widely-held firms prevail, hostile takeovers are relatively rarely used. Over the 1990s, 239 hostile takeovers were announced in the US and 158 in the UK. This constitutes 2.3 and 6.5 percent of the total number of announced tender offers, respectively. There were only 67 hostile bids in the 14 EU countries (excluding the UK), representing 1.3 percent of all tender offers announced during this period (Thomson Financial Securities Data (2004)). In most other countries they are even rarer.

opportunity for target shareholders are likely to discourage the monitoring of managers via the market for corporate control and vice versa.⁹

A second trade-off arises with respect to the two main functions of takeover regulation: the promotion of efficient corporate restructuring, and the reduction of agency conflicts and the protection of minority shareholders. The trade-off is similar to the previous one, but relates to the broader definition of corporate restructuring, which apart from the hostile takeover mechanism, includes the reallocation of capital to better managers. As such, the second trade-off is equally important in countries with dispersed ownership and those with concentrated ownership. Takeover regulation also indirectly affects the incentives for a company to seek a listing on the stock exchange. If the incumbent owners value control, they will often be reluctant to take their firm public if this exposes them to an active market for corporate control. Their reluctance to take their firm public depends on the distribution of gains from a future takeover bid, which is determined by takeover regulation. Furthermore, regulation that is likely to reduce the power of the blockholders discourages a listing. This constitutes a third trade-off of the regulation: promoting the expansion of financial markets, and supplying corporate governance devices aimed at protecting the rights of corporate constituencies.

No clear guidelines are available as to how the above trade-offs should be made. The way the trade-offs are made critically depends on the broader (national) corporate governance framework and the economic and political objectives of national regulators.

4. Reforms of takeover regulation and corporate governance convergence

As takeover regulation is an important corporate governance device, any attempts to change its provisions have a significant impact on the wider corporate governance system. Not only do changes in takeover regulation affect the level of investor protection and the development of a country's takeover market, but they may also bring about changes in ownership and control. As such, takeover regulation reforms provide an important channel for a corporate governance system to evolve. It would be misleading to conclude that the harmonization of takeover regulation across countries will lead to global convergence of corporate governance regimes as the corporate governance functions of takeover regulation depend on the degree of ownership and control concentration.

⁹ Regulatory provisions that allocate more takeover surplus to the bidding firm increase the bidder's incentive to make a bid to acquire a poorly performing firm and replace its inefficient management upon the acquisition of control. However, such provisions may dilute rights of the target company's incumbent shareholders. Takeover provisions that provide exit opportunities for minority shareholders redistribute the takeover surplus from the bidder to the target shareholders and hence make a takeover bid less attractive for the former.

Takeover regulation reforms, which focus on the conflict of interests between management and shareholders, are likely to improve investor protection. Depending on the provisions introduced by the regulation, the reforms either improve the efficiency of the external monitoring by the market for corporate control, or restrict managerial decision power with respect to the use of anti-takeover devices. Since both types of provisions force managers to satisfy the interests of the shareholders, shareholder protection is expected to improve, should these provisions be adopted. La Porta et al. (1999) argue that better protection increases shareholders' confidence and hence their willingness to invest, which encourages a more dispersed ownership structure.

Regulatory reforms that introduce exit opportunities for minority shareholders reduce the private benefits of control that the controlling blockholder can exploit at the detriment of these minority shareholders. This improves the protection of the latter. Low private benefits of control can be regarded as a requirement for ownership dispersion, as they reduce the incentives to hold a controlling block. However, regulatory provisions that reduce the private benefits of control may discourage not only holding controlling blocks of ownership, but also efficient corporate restructuring as private gains to a bidder are often an incentive for a takeover bid. As a result, control may remain in the hands of inefficient blockholders. Hence, the effect of such reforms may result in either the upholding of the existing concentrated ownership and control or in a shift from dispersed to concentrated shareholdings.

An increase in investor protection or a decrease in private benefits of control alone may be insufficient to induce changes in ownership. Bebchuk (1999) shows that, in the presence of large private benefits of control and a well-functioning takeover market, ownership is unlikely to become more dispersed. Since a third party acquiring a controlling block is unable to compensate the incumbent blockholder for the private benefits of control the latter enjoys, it is unlikely that the incumbent ever accepts a bid. Thus, where private benefits of control are high, regulatory reforms aimed at improving investor protection are likely to reinforce the existing ownership structure. Roe (2002) proposes an alternative scenario. In his view, if the costs of monitoring management are high, the development of a well-functioning market for corporate control may lead to a shift from concentrated to dispersed ownership. An active takeover market incorporates the costs of potential agency costs caused by high managerial discretion by providing efficient external monitoring, and thus reducing the need for large-shareholder monitoring. This shift towards widely-held ownership may be further supported by other drawbacks of large share blocks such as the costs from low liquidity and undiversified risk. We conclude that takeover regulation reforms that enhance investor protection are likely to lead towards more dispersed ownership provided that private benefits of control are relatively low. It also follows from Bebchuk (1999) and Roe (2002) that, when investor protection is already high, reforms aiming at reducing private benefits of control may bring about ownership dispersion. However, if management has substantial discretion to

apply anti-takeover measures, the preferred ownership distribution may shift towards a more concentrated structure even if private benefits of control are reduced. Table 1 summarizes the above conjectures.

Table 1. Reforms of takeover regulation and their expected impact on ownership and control within a particular corporate governance system

<i>Initial characteristics of the system</i>	<i>Takeover regulation reforms</i>	<i>Expected effect on the ownership structure</i>
Low investor protection (High managerial discretion)	Decrease in private benefits of control	Remains concentrated
High investor protection (Effective external monitoring of managers)	Decrease in private benefits of control	More dispersed
Low private benefits of control	Improve investor protection	More dispersed
High private benefits of control	Improve investor protection	Remains concentrated

The European Commission tried to establish a global level-playing field for a takeover market. However, the adoption of such a unified takeover code by countries with different initial settings may disperse ownership in some of them, but may further consolidate the blockholder-based system in others. Since the blockholder-based system lacks a market for corporate control, any further reinforcement of this system caused by the takeover law harmonization may disable the attempts to establish such an international level-playing field.¹⁰

5. Devices of takeover regulation

As discussed in section 3, takeover regulation should ensure a well-functioning market for corporate control and protect the interests of minority shareholders and other types of stakeholders. The regulatory devices available to achieve these two aims are manifold and comprise: (i) the mandatory bid rule, (ii) the principle of equal treatment of shareholders, (iii) ownership and control transparency, (iv) squeeze-out and sell-out rules, (v) the one-share-one-vote principle, (vi) the break-through rule, and (vii) board neutrality with respect to anti-takeover measures. This section discusses the role of each device as well as its potential consequences for the ownership structure. Table 2 summarizes the conjectures presented below.

5.1 The mandatory bid rule

¹⁰ For more details on this issue, see Becht (2003)

The mandatory bid rule provides the minority shareholders with an opportunity to exit the company on fair terms. The rule requires the acquirer to make a tender offer to all the shareholders once she has accumulated a certain percentage of the shares. Whereas about a decade ago, a tender offer on all shares outstanding was only mandatory after an investor had acquired de facto majority control, nowadays thresholds are substantially lower. For instance, there has been a decrease in the thresholds in Denmark and Italy. In these countries, a tender offer needs to be made to all the remaining shareholders as soon as the bidder has accumulated one third of the company's equity. The mandatory bid rule usually also dictates the price of the tender offer. Depending on the national regulation, the price must not be lower than the highest price paid for the shares already acquired by the bidder or must not be lower than a certain percentage of the average share price of the previous 12 months (e.g. 75%). The mandatory bid requirement is justified on the grounds that an investor, who obtains control, may be tempted to exploit private benefits of control at the expense of the minority shareholders. As such, the role of the mandatory bid rule in takeover regulation is to protect the minority shareholders by providing them with the opportunity to exit at a fair price.

Although the mandatory bid requirement may mitigate the problem of expropriation of minority shareholders, it also decreases the likelihood of value-creating restructuring (Burkart and Panunzi, 2004). The main reason for this is that the rule makes control transactions more expensive and thereby discourages bidders from making a bid in the first place. There are several ways to reduce these costs. First, the costs can be reduced by increasing the threshold above which the acquirer has to make a mandatory offer. Second, the costs can be reduced by allowing the price in the tender offer to be lower than the highest price paid for any of the shares previously accumulated. Third, they can be reduced by granting further exceptions to the rule rather than just for financial distress of the target. However, any of the suggested modifications to the rule increase the likelihood that minority shareholders are expropriated and violate the equal treatment principle of corporate law.

Introducing a mandatory bid rule has some implications for the ownership and control structure in a blockholder system. First, it makes the blockholder system less efficient, as it reduces the trade in controlling blocks which is the dominant way to transfer control in this system (Köke and Renneboog, 2004). Consequently, control may remain in the hands of inefficient blockholders. Second, it restricts the size of the stake a blockholder is allowed to acquire without triggering a tender offer. Third, the higher the bid price in a mandatory tender offer, the lower is the acquirer's incentive to make a bid such that ownership and control in the blockholder system is likely to remain concentrated.

In contrast to the blockholder system, the shareholder-oriented system with its dispersed ownership structure is almost unaffected by the introduction of the mandatory bid rule. Although

the requirement to make a tender offer may reduce the intensity of M&A activity and hence provide managers with greater discretion, it is unlikely to result in a more concentrated ownership structure.

5.2 The principle of equal treatment

While the principle of equal treatment constitutes an important principle of corporate governance regulation, it is particularly important in takeover regulation where the possibilities of violations of the rights of minority shareholders are far-reaching. The principle requires controlling shareholders, the management, and other constituencies to treat all shareholders within each individual class of shares equally. The equal treatment requirement became a fundamental principle in almost all Western European countries prior the 1990s. During the 1990s, it was introduced in Switzerland¹¹ as well as in Central and Eastern European countries.¹²

The equal treatment principle requires an acquirer the opportunity to offer minority shareholders to exit on terms that are no less favourable than those offered to the shareholders who sold a controlling block. Overall, the role of the equal treatment principle in takeover regulation is similar to the mandatory bid rule as both aim at protecting minority shareholders.

The adoption of the principle of equal treatment substantially affects the blockholder system, but has virtually no effect on the market-based system. In target companies with concentrated ownership, an acquirer usually has to offer a control premium to the incumbent blockholder reflecting the potential private benefits of control. If there is a mandatory bid requirement, the bidder has to repurchase the remaining shares at a price no less than the one she paid for the controlling block. Therefore, the combination of the mandatory bid and the equal treatment principle increases the costs of an acquisition and decreases the price that a bidder is able to offer to the controlling shareholder (Davies and Hopt, 2004). This discourages the incentives to make a bid, as well as the incentives for incumbent blockholders to accept one. Consequently, the equal treatment principle is an additional barrier to a well-functioning market for corporate control in a blockholder-based governance regime.¹³ Nonetheless, the equal treatment principle may cause

¹¹ Until 1992, the principle was unwritten, but generally recognized at the level of company law. As from the 1992-revision, it was incorporated in the law (art. 717 sec. 2 CO) in a qualified manner, providing for equal treatment under equal circumstances. Although the principle refers to the treatment of shareholders by the board of directors, it is recognized as a general principle. At the level of stock exchange regulations, takeover offers have had to comply with the principle of equal treatment of shareholders (art. 24 sec. 2 SESTA) since 1998.

¹² For example, in Bulgaria, the principle is contained in Art.181, Para. 3 of the Trade Act of 2000. In Cyprus, Section 69A of the Companies Law introduced in 2003 states that: “the shareholders of a class of shares of a public company shall be equally treated by the company”. In the Czech Republic, it was introduced in 2001 (§ 155/7 of the Commercial Code)..

¹³ It is only in the absence of large private benefits of control that private negotiations with the incumbent controlling blockholder are likely to result in lower costs for a control transfer than an open market purchase from

a shift towards more dispersed ownership, as it discourages the accumulation of controlling share blocks in the long run. Conversely, Bebchuk (1999) predicts that concentrated ownership will prevail, especially when the principle of equal treatment is not enshrined in corporate law.

5.3 Transparency of ownership and control

An important element of corporate governance consists in the disclosure of voting and cash flow rights. In all Western countries, the disclosure regulation relates to voting rights rather than cash flow rights (see the country studies in Barca and Becht (2001)). Virtually all of these countries have recently lowered the thresholds above which the ownership of control rights need to be disclosed. In some countries, the 'strategic intent' or the purpose for which the share stake was acquired also has to be disclosed. Thus, in the early 1990s, the average threshold for disclosure in Western Europe and Scandinavia was about 9 percent, with the UK having the lowest threshold (3 percent), and Germany the highest threshold (25 percent). In countries such as Italy and Sweden, a mandatory disclosure of voting rights was introduced for the first time as late as 1992. By 2004, the average threshold was reduced to 5 percent with the lowest threshold of 2 percent in Italy and the highest one of 10 percent in Luxembourg and Sweden. Information about major share blocks allows the regulator, minority shareholders and the market to monitor large blockholders in order to avoid that the latter extract private benefits of control at the expense of other stakeholders. In other words, transparency minimizes potential agency problems *ex ante*. Moreover, transparency allows the regulator to investigate, for instance, insider trading or self-dealing by large blockholders.

Conversely, a higher threshold for the mandatory control disclosure improves the efficiency of the hostile takeover mechanism (Grossman and Hart, 1980). Bidders can make substantial profits on the toehold stake they built up prior to reaching the disclosure threshold. The disclosure of the acquisition of a major stake may alert the market that a bid is likely to take place. This will lead to a revision of the share price that may then reflect the likely gains from the takeover. The higher the thresholds for the ownership disclosure and the mandatory bid, the lower is the number of shares for which the bidder pays the full takeover premium. Conversely, lowering the disclosure and mandatory bid thresholds will cause a fraction of potential takeovers not to be undertaken.¹⁴

However, a decrease in the disclosure threshold is unlikely to have a substantial impact on control. On the one hand, lowering the disclosure threshold reduces the bidder's incentives to

dispersed shareholders (Bagnoli and Lipman, 1988, Holmström and Nalebuff, 1990, and Burkart, Gromb, and Panunzi, 1997). The presence of controlling shareholders in companies may then facilitate an active market for corporate control.

¹⁴ See e.g. Shleifer and Vishny (1986), Hirshleifer and Titman (1990), Kyle and Vila (1991), and Burkart (1999).

make a bid, which may lead to less efficient external monitoring of management. On the other hand, a lower threshold enhances the disclosure of information and hence positively affects investor protection. As it is unclear which effect dominates, the impact of a tightening of control disclosure on the shareholding structure is ambiguous.

5.4 The squeeze-out and sell-out rules

The squeeze-out rule gives the controlling shareholder the right to force minority shareholders, who hold out in a tender offer, to sell their shares to the bidder at or below the tender offer price (Boehmer (2002), and Becht, Bolton and Röell (2003)). The squeeze-out rule only kicks in, if the bidder has acquired a specific percentage of the equity, usually 90%.¹⁵ The rule allows the bidder to obtain 100% of the equity and frees him from having to deal with minority shareholders. The squeeze-out rule affects the behaviour of the target shareholders during a tender offer as it reduces the hold-out problem and may lead to a decrease in the tender price.¹⁶ According to Yarrow (1985) and Maug (2004), the economic efficiency of the squeeze-out rule depends on how the price at which the minority shares are squeezed out is determined. For example, Maug's model predicts that economic efficiency worsens if minority shareholders extract higher premiums in squeeze-outs. If these premiums are higher than those offered in the tender offer, then few will be tempted to tender in the first place.

The sell-out rule is another provision aiming at protecting the remaining minority shareholders who have the right to demand the controlling shareholder to buy their shares at a fair price. The rule reduces the pressure on the target shareholders to tender. As a consequence, this rule has a negative impact on the likelihood of acquisitions occurring. Although the sell-out rule is seen as a counter-provision to the squeeze-out rule, the two rules are used jointly in many jurisdictions. The proposed European Takeover Directive contains both the squeeze-out and sell-out rights.

Summarizing the above discussion, the squeeze-out rule mitigates potential free-riding behaviour by small shareholders, thereby allocating more of the takeover gains to the bidder. In addition, the rule eliminates the potential problems that may arise between the controlling shareholder and the remaining minority shareholders after most of the target's shares have been

¹⁵ Across countries, there is some variation in the threshold above which the bidder can squeeze out the remaining minority shareholders. Ireland has the lowest threshold with 80 percent. The usual threshold in Western European countries is 90 percent, while Belgium, France, Germany, and the Netherlands impose the highest threshold, 95 percent. However, 95 percent became the highest threshold only in 1998 when Italy and Switzerland reduced their squeeze-out threshold from 98 to 90 percent.

¹⁶ When a bid is conditional on the squeeze-out threshold, shareholders cannot gain from retaining shares. Hence, they are willing to tender at prices below post-takeover minority share value. Therefore, bidders who condition their bid on a squeeze-out threshold should earn higher returns.

acquired. Hence, the squeeze-out rule is expected to facilitate takeovers and its introduction may have a positive impact on the development of a takeover market. In contrast, the sell-out rule reduces the share of takeover gains allocated to the bidder, thereby discouraging some value-creating takeovers. The rule is aimed at protecting minority shareholders. Like the squeeze-out rule, the sell-out right also eliminates potential conflicts between the majority shareholder and the minority shareholders. The adoption of the two rules may reduce the incentives of holding controlling blocks and may thus reduce ownership concentration in the long run.

5.5 The one-share-one-vote principle

The one-share-one-vote principle speaks against any arrangements restricting voting rights. Dual-class shares with multiple voting rights, non-voting shares and voting caps are forbidden if this legal principle is upheld. The issue of dual class shares or non-voting shares allows some shareholders to accumulate control while limiting their cash investment. Another way to deviate from the one-share-one-vote principle is via pyramids of control. The use of intermediate holding companies allows the investor at the top of the pyramid – the ultimate shareholder – to have control with reduced cash flow rights. Renneboog (2000) and Köke (2004) show that for Belgium and Germany, respectively, it is the ultimate shareholder rather than direct shareholders who monitors the firm and exercises control.

The potential benefit from introducing differentiated voting rights is that more firms may seek a stock exchange listing. Company owners who value control are often reluctant to take their firm public if they risk losing control in the process. A deviation from the one-share-one-vote rule allows them to minimize the risk of losing control. Hart (1988) argues that a deviation from the one-share-one-vote principle is unlikely to hurt minority shareholders as the lack of control rights is compensated by the lower offer price at the flotation.

Becht, Bolton and Röell (2003) review the theoretical literature which addresses whether deviations from the one-share-one-vote rule improve the efficiency of the takeover mechanism. Grossman and Hart (1988) show that, if shareholdings are dispersed, the one-share-one-vote rule ensures a socially efficient outcome of a takeover bid because it enables the bidder who values the target the most to gain control. Furthermore, deviations from the rule may harm the development of a market for corporate control. First, given that differentiated voting rights facilitate the control by a few owners, this makes a takeover virtually impossible without a break-through rule (see subsection 5.6). Second, although violations of the one-share-one-vote rule such as voting agreements can curb the power of the controlling shareholder and provide greater protection to minority shareholders, they may also increase managerial discretion and discourage potential value-increasing takeovers (Crespi and Renneboog, 2003). Third, voting restrictions such as voting caps

represent important anti-takeover devices that discourage potential bidders from making an offer. However, such voting restrictions provide greater protection to minority shareholders.

Preventing deviations from the one-share-one-vote principle has a two-fold effect on ownership and control. First, it eliminates barriers to the takeover market, and therefore protects investors against opportunistic managerial behaviour. This may translate into a greater willingness of small investors to participate in equity financing which leads to a more dispersed shareholding structure. Thus, the one-share-one-vote rule may be an important corporate governance device, especially for firms with a dispersed ownership structure. Second, a reform that bans deviations from the rule reduces minority shareholder protection, increases the potential private gains of control and encourages ownership concentration. Thus, the impact of the introduction of the one-share-one-vote principle to the blockholder system is still ambiguous, as it depends on whether the effect from the protection against opportunistic behaviour of incumbent managers or that from the reduced shareholder protection resulting from the abolition of voting caps dominates.

5.6 The break-through rule

The effects of a violation of the one-share-one-vote principle via dual class shares, non-voting shares or voting caps, can be undone if corporate law allows for a break-through rule. This rule enables a bidder who has accumulated a given fraction of the equity, to break through the company's existing voting arrangements and exercise control as if the one-share-one-vote principle were upheld. For example, a recently acquired block consisting of a majority of non-voting rights may be converted into a voting majority by means of the break-through rule. The rule facilitates corporate restructuring as it allows the bidder to bypass anti-takeover devices and redistributes the takeover gains from the incumbent shareholders to the bidder.¹⁷ Thus, the break-through rule makes transfers of control feasible that would otherwise have been made impossible due to the opposition by a target shareholder holding a majority of voting shares.

However, the break-through rule also has some major disadvantages. First, there is inconsistency between the break-through rule and the mandatory bid rule. The break-through rule gives control by circumventing the provisions in the articles of association rather than by acquiring a certain percentage of voting shares. As such, the break-through rule violates the principle of shareholder decision-making. Second, in addition to making value-increasing takeover bids

¹⁷ Berglöf and Burkart (2003) argue that the break-through rule reduces the costs associated with the acquisition of all minority shares as imposed by the mandatory bid rule. They compare the takeover price that a bidder is expected to pay in order to acquire 100% of the company's equity under two scenarios: (1) the case of a negotiated block trade with an incumbent shareholder and a subsequent mandatory bid, and (2) the case of a direct tender offer to non-controlling shareholders (bypassing the incumbent shareholder controlling a majority of the voting rights) with the subsequent application of the break-through rule. They show that the break-through rule reduces the acquisition costs compared to a negotiated block trade followed by a mandatory bid.

possible, the break-through rule also facilitates takeover attempts by inefficient bidders who would otherwise be discouraged by the mandatory bid requirement. Third, the rule not only makes inefficient acquisitions possible, but also frustrates attempts by the incumbent shareholders to prevent such bids. Finally, the main concern is that the break-through rule will induce the creation of even more complex pyramids and cross-holdings (Bebchuk and Hart, 2002). The reason is that such voting structures are not covered by the break-through rule which only targets voting caps, non-voting shares and multiple-voting shares. Technically, shifts towards pyramidal ownership structures could disable most of the advantages of the break-through rule.

The direct effect of the break-through rule within the blockholder-based system is the decrease in the costs of successful bids. This decrease promotes takeover activity and facilitates transfers of control. However, Berglöf and Burkart (2003) argue that the rule fundamentally alters the initial contracts of the controlling owners resulting in uncertainty about property rights, and thus reducing the incentives of the controlling owners to invest in corporate governance actions. The rule also eliminates their veto over transfers of control and reduces their prospects of getting compensated for their private benefits of control. Overall, this suggests that the introduction of the rule should eventually increase ownership dispersion. However, as argued above, the emergence of more complex control structures such as pyramids and cross-shareholdings to circumvent the breakthrough rule may reinforce the blockholder model. Therefore, we conclude that the long-run impact of the break-through rule on ownership is unclear as it depends on the blockholders' ability to build up share stakes via pyramids.

5.7 Board neutrality and anti-takeover measures

Although the takeover market is considered to be an external corporate governance mechanism that forces managers to act in the interests of the shareholders, it can also be a source of even greater divergence of interests between these two parties. In the wake of a takeover threat, the management of the target company potentially faces a conflict of interests: the transaction may create shareholder value, but also endangers their jobs and perquisites. If the management of the target firm has unrestricted power, the line of actions chosen may focus on their own interests and hence on the prevention of a takeover. This calls for a set of rules that govern the behaviour of management and shareholders when a takeover offer is imminent. The rules deal with the issues of who decides whether to reject or accept the offer, the adoption of takeover defences and the bargaining strategy with the bidder. The rules mainly apply to widely-held companies where the problem of managerial discretion is especially pronounced.

There are two solutions for mitigating the managerial agency problem in a takeover context (Davies and Hopt (2004)). The first is to transfer the decision as to the acceptance of a bid to the

shareholders of the target company and to remove it from the management. Unless the regulator forbids this, the management can only influence the decision by taking actions that discourage potential bidders from making an offer in the first place or by prolonging the offer process. Examples of such actions are the attempt to make the company less attractive to a potential bidder, the advice to the target shareholders to reject the bid, and the search for a white knight.

Currently, several jurisdictions impose board neutrality with respect to takeover offers, preventing the board of directors from taking actions that may frustrate a potential bid. For example, the use of poison pills is forbidden in most European countries. The main argument in favour of board neutrality is that it limits the potential coercive effect of a bid (Bebchuk (2002), Arlen and Talley (2003)). In most jurisdictions, the board should indeed remain neutral and limit the use of anti-takeover devices unless an anti-takeover strategy was approved by the shareholders at a general meeting and only once a bid has been made.¹⁸

The second solution is to provide the board with substantial decision power, but to give the shareholders the possibility to veto its decisions. The board has then the right to negotiate with a bidder on behalf of the shareholders. This arrangement mitigates the coordination problem between small shareholders in case of dispersed ownership and the agency problems of other stakeholders such as the employees. In a second stage, the shareholders are asked to approve or reject the managerial advice. Although this arrangement gives more flexibility to the target management to act against potentially undesired bids by setting up an anticipatory anti-takeover strategy, there is also more opportunity for the managers to pursue their own interests. Therefore, additional corporate governance devices should be introduced, such as the strengthening of the independence of the non-executive directors, and the use of executive compensation contracts that align managerial interests with those of the shareholders.

The first solution effectively addresses the potential agency problems between shareholders and management of the target in the wake of a takeover. However, its weakness is that the defensive tactics can only be applied once a bid has been received and not prior to receiving a bid. In contrast, the second solution provides management with the flexibility to prevent value-destroying takeovers *ex ante*. However, this mechanism may increase the agency problem between management and shareholders. Both solutions are applied in the real world. The first one is used mainly in the UK and in most of Continental Europe, whereas the second one is applied in the US and some European countries such as the Netherlands. Germany has opted for a mix of the two.

The two solutions have implications not only in terms of the relative importance of agency problems and the development of the market for corporate control, but also in terms of ownership.

¹⁸ Where ownership and control are concentrated, if the law requires the approval of a defensive measure by a majority of shareholders at the AGM, a controlling shareholder can easily oppose any takeover attempt. Therefore, it is important to allow for deviations from the one-share-one-vote rule in favour of the minority shareholders when the adoption of defensive measures is up for a vote.

Roe (2002) predicts that, under the second solution, ownership may become more concentrated as management has substantial discretion to apply anti-takeover measures and costs associated with managerial discretion are high. If ownership is concentrated, the first solution may encourage better minority shareholder protection as it reduces the power of the managers acting in the interests of the large blockholder. In this case, ownership is likely to become more dispersed. However, this may be true only if the voting power of the controlling blockholder is also restricted. Otherwise, ownership will become even more entrenched in the hands of the controlling blockholder as he will have power to affect any corporate decisions not through management but directly.

Table 2. Expected consequences of takeover regulation reform (summary of the conjectures discussed in section 5)

Elements of Takeover regulation	Concentrated ownership structure			Dispersed ownership structure		
	Impact on M&A activity	Impact on minority shareholder protection	Impact on ownership structure	Impact on M&A activity	Impact on target shareholder protection	Impact on ownership structure
1 The Mandatory bid rule:	Less trade in controlling blocks	Better protection	More concentration	Fewer M&As	Better protection	No impact
1.1 Lower mandatory bid threshold	Fewer M&As	Better protection	More dispersion	Fewer M&As	Better protection	No impact
1.2 Higher price at which the bid should be made	Fewer M&As	Better protection	Ambiguous	Fewer M&As	Better protection	No impact
1.3 No equal treatment requirement	More M&As in form of two-tier offers	Expropriation of minorities	More concentration	More M&As in form of two-tier offers	Expropriation of incumbent shareholders	More concentration
1.4 Equal treatment requirement (in the presence of high private benefits of control)	Fewer M&As	Better protection	Ambiguous (more dispersion)	No impact	Better protection	No impact
1.5 Equal treatment requirement (in case of low private benefits of control)	More M&As	No impact	More dispersion	No impact	No impact	No impact
2 The Equal treatment principle	Fewer M&As	Better protection	More dispersion	No impact	No impact	No impact
3 Ownership and control transparency (Lower disclosure threshold)	Fewer M&As	Better ex-ante protection	Ambiguous	Fewer M&As	Better ex-ante protection	Ambiguous
4 The Squeeze-out Rule	More M&As	Better protection	More dispersion	More M&As	Better protection	No impact
5 The Sell-out rule	Fewer M&As	Better protection	More dispersion	Fewer M&As	Better protection	No impact
6 Ban on the deviation from the One share/One vote principle	More M&As	Ambiguous (Less protection)	Ambiguous	More M&As	Ambiguous (Less protection)	No impact
7 Breakthrough rule	More M&As	Less protection	Ambiguous	More M&As	Less protection	Ambiguous
8 Management neutrality and limitations on anti-takeover measures:	More M&As	Ambiguous (Better protection)	Ambiguous	More M&As	Ambiguous (Less protection)	No impact
8.1 Management is decision-taker, anti-takeover devices can be installed only when a bid occurs	More M&As	Ambiguous	Ambiguous	More M&As	Less protection	No impact
8.2 Management is decision-maker, anti-takeover devices can be installed prior to a bid	Fewer M&As	Ambiguous	Ambiguous	Fewer M&As	Better protection	More concentration

6. Reforms of takeover regulation in Europe over the period of 1990-2004

The history of takeover regulation in Europe goes back to 1968 when the UK introduced a voluntary code, the City Code on Takeovers and Mergers in response to a series of large takeovers. Since then, the Code has been frequently amended. The two main provisions of the City Code are a mandatory bid rule with a threshold of 30 percent beyond which a tender offer becomes compulsory, and the prohibition to discriminate against certain shareholders. Other important provisions concern the actions of the bidder prior to the bid announcement, the information about the bid issued to the target shareholders, and the defensive measures available to the target. The Code also stipulates managerial neutrality as it prohibits management to take any actions against a takeover without shareholder consent.

Takeover regulation in Continental Europe was only put in place during the late 1980s following a dramatic increase in takeover activity. Many Continental European jurisdictions used the British City Code as a benchmark (Hopt (2002), and Berglöf and Burkart (2003)). Initially, Continental Europe came up with voluntary codes which were replaced by binding rules in the mid-1990s. However, even to date some countries have purely voluntary codes in place. In the late 1990s, there was a new wave of reforms in response to the fifth takeover wave. A third of these takeovers were cross-border transactions. The European Commission set up the High Level Group of Company Law Experts headed by Professor Jaap Winter to make recommendations on the harmonization of European corporate law, and takeover regulation in particular. In 2002, the Commission presented the first draft of the Takeover Directive based on the recommendations of the Group. This draft focused on the introduction of five provisions regarding: (i) a mandatory bid rule, (ii) the principle of equal treatment of shareholders, (iii) a squeeze-out rule and sell-out right, (iv) the principle of board neutrality, and (v) a break-through rule. The fifth provision of the proposed Directive met with substantial opposition from EU member states and was not approved.

While the European Commission attempted to harmonize takeover regulation at the European level, most member countries were already engaged in reforming their national takeover legislation. The dynamics of the European takeover reforms are presented in Figures 3 to 10. We classify all countries into six groups according to their legal origin and economic development, following La Porta et al. (1997). Countries from the former communist block are classified according to their (staged) accession to the European Union, as this event has probably an important impact on their legislative reforms. Figures 1 and 2 show an overview of the ultimate control in European countries in the late 1990s.¹⁹ Since major takeover regulation reforms took

¹⁹ Faccio and Lang (2002) argue that the ownership and control structure in Western countries was relatively stable over the 1990s. Hence, the ownership and control structures in Figures 1 and 2 are also representative for the

place in the late 1990s, we predict how these ownership patterns may evolve as a result of the reforms.

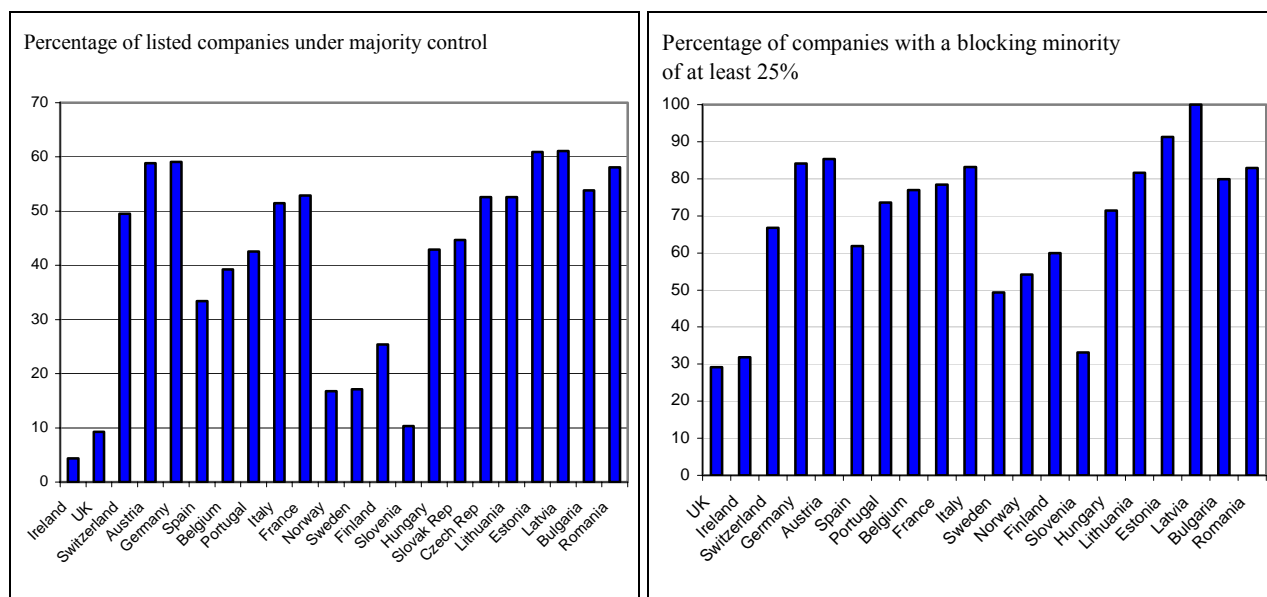


Figure 1. Percentage of listed companies under majority control

Figure 2. Percentage of listed companies with a blocking minority of at least 25%

Data source: Faccio and Lang (2002) for the countries with law of English, German, French, and Scandinavian origin, the ECGI project "Corporate Governance & Disclosure in the Accession Process" (2001) for the EU accession countries.

Figures 1 and 2 show that the blockholder-based regime prevails in most of Continental Europe and is characterized by majority or near-majority holdings of stock held in the hands of one, two, or a small group of investors. In contrast, the market-based system, which is found in the UK and the Republic of Ireland, is characterized by dispersed equity. Although the difference in ownership between Continental Europe, on the one hand, and the UK and Ireland, on the other, is remarkable, there is also some variation in the percentage of companies under majority or blocking minority control across the Continental European countries. Thus, Figure 1 shows that countries of Scandinavian legal origin have the lowest percentage of companies controlled by a majority blockholder whereas countries of German legal origin and recent EU accession countries (except for Slovenia) have the highest percentage. The percentage varies from just above 10 percent in Slovenia to more than 60 percent in Estonia and Latvia. Figure 2 reports that the percentage of Continental European companies controlled by investors with blocking minorities of at least 25 percent is very high. The difference across countries is less pronounced though, as in almost all more than 50 percent of listed companies have a controlling blockholder. As discussed in sections

early and mid 1990s. However, this is not a valid statement for the recent EU accession countries, which experienced a wave of privatisations in the early 1990s.

3 and 4, the effects of the reforms and their effectiveness may be different in each country given the differences in control. However, different patterns of voting power also imply that different types of takeover provisions are likely to be introduced in the takeover law.

Figure 3 shows that the mandatory bid rule had been widely adopted across the different groups of countries by 2004. Resistance towards the rule remains in countries of Scandinavian (e.g. Sweden) and French (e.g. Luxembourg and the Netherlands) legal origin. Amongst the countries that became EU members in 2004, only Cyprus did not adopt it. All three candidates earmarked for EU membership in 2007 – Bulgaria, Croatia, and Romania – have already adopted the rule. Despite the widespread adoption of the rule, its settings vary substantially across the countries both with respect to the threshold and the price at which the offer must be made. The threshold varies between 20 percent and two-thirds of the voting capital, with the majority of countries having a threshold of one-third of the voting rights. However, a number of countries have not specified a threshold and instead require a mandatory bid as soon as control has been obtained. Moreover, Switzerland²⁰ allows shareholders of a potential target to choose whether to apply the mandatory bid rule or not. The rules on the fixing of the price in the mandatory offer also differ across jurisdictions. For example, the UK²¹ and Germany²² require the price to be equal to the highest price paid for pre-bid purchases. Other jurisdictions have opted for a more flexible approach. In Italy, the price has to be equal to the average market price over the 12 months prior the bid announcement²³ whereas in Switzerland it has to be at 75 percent of the highest pre-bid market price.²⁴

²⁰ Art. 22(2) and 32(1) Loi sur les bourses. However, to use this option companies need to mention this option explicitly in the company's articles of incorporation.

²¹ Rule 9.5, 6, and 11 City Code.

²² Par. 4 Übernahmegesetz – Angebotsverordnung and Par. 31 Übernahmegesetz.

²³ Art. 106(2) Legislative Decree 58.

²⁴ Art. 32(4) Loi sur les bourses.

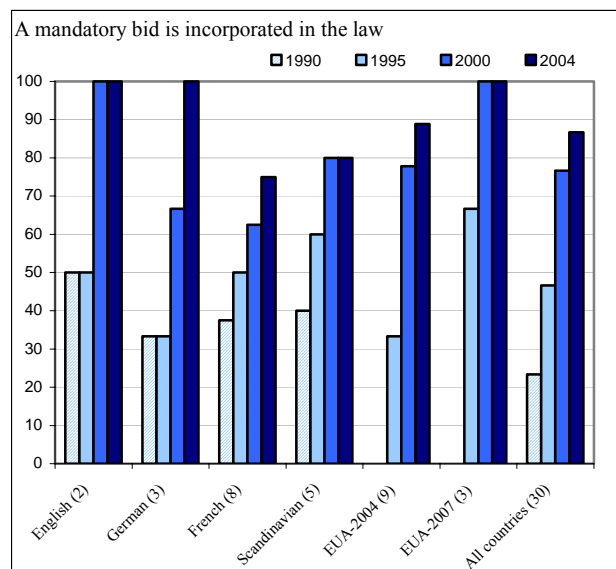


Figure 3. Adoption of the mandatory bid rule

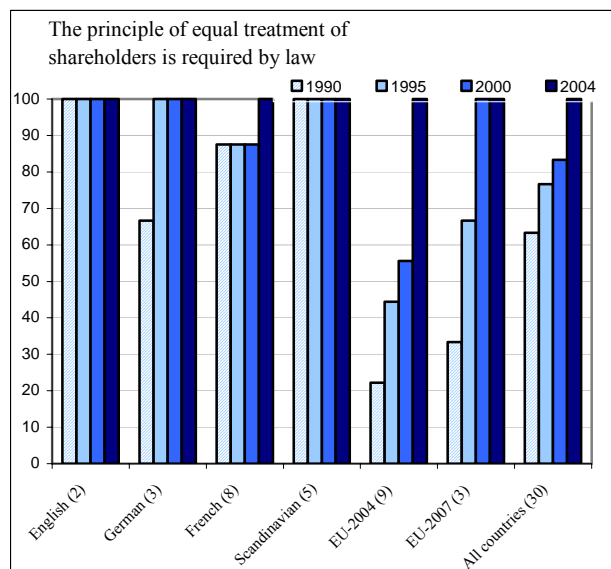


Figure 4. Adoption of the equal treatment principle

Notes: Countries are grouped according to their legal origin following the classification by La Porta et al. (1997) and according to the EU enlargement process. Countries are grouped as follows: *English legal origin* (Republic of Ireland and the UK), *German legal origin* (Switzerland, Austria, Germany), *French legal origin* (Spain, Belgium, Portugal, Italy, France, The Netherlands, Luxembourg, and Greece), *Scandinavian legal origin* (Norway, Sweden, Finland, Denmark, and Iceland), *2004 EU Accession* (Slovenia, Hungary, Slovak Republic, Czech Republic, Lithuania, Estonia, Latvia, Poland, and Cyprus), *2007 likely EU Accession* (Bulgaria, Romania, and Croatia). The Y-axis shows the percentage of countries in each group that have adopted this rule. *Martynova and Renneboog (2004) corporate governance database*.²⁵

In contrast to the diversity in terms of the adoption and provisions of the mandatory rule, Figure 4 reports that there is widespread consensus in Europe with respect to the principle of equal treatment of shareholders. In the US, there is no such consensus at the state level. Davies and Hopt (2004) report that two-tier offers, which violate the equal-treatment requirement, ‘do not offend the provisions of the Williams Act in the US’.²⁶ The equal treatment requirement had already been adopted as a fundamental principle by almost all the Western European countries prior to the 1990s. During the 1990s, it was introduced in Switzerland²⁷ and in Central and Eastern European countries.²⁸

²⁵ The Martynova-Renneboog (2004) database is described in the Appendix.

²⁶ The Williams Act, 15 U.S.C. § 78a, prohibits first-come, first-served offers but not two-tier tender offers. The latter involve two parts: in the first tier offer, the bidder pays a premium above the market price for a controlling block, whereas in the second tier, the terms are much less favourable. Although this system mitigates the shareholders’ hold-out problem in a tender offer and hence stimulates the takeover market, it also pushes shareholders to tender even if they believe the bid is inadequate. To resolve this problem, US companies resort to poison pills (Subramanian (1998)).

²⁷ Until 1992, the principle was unwritten, but generally recognized at the level of company law. As from the 1992-revision, it was incorporated in the law (art. 717 sec. 2 CO) in a qualified manner, providing for equal treatment under equal circumstances. Although the principle refers to the treatment of shareholders by the board of directors, it is recognized as a general principle. At the level of stock exchange regulations, takeover offers have had to comply with the principle of equal treatment of shareholders (art. 24 sec. 2 SESTA) since 1998.

²⁸ For example, in Bulgaria, the principle is explicitly provided in Art.181, Para. 3 of the Trade Act of 2000. In Cyprus, Section 69A of the Companies Law which was introduced in 2003 provides that: “the shareholders of a class

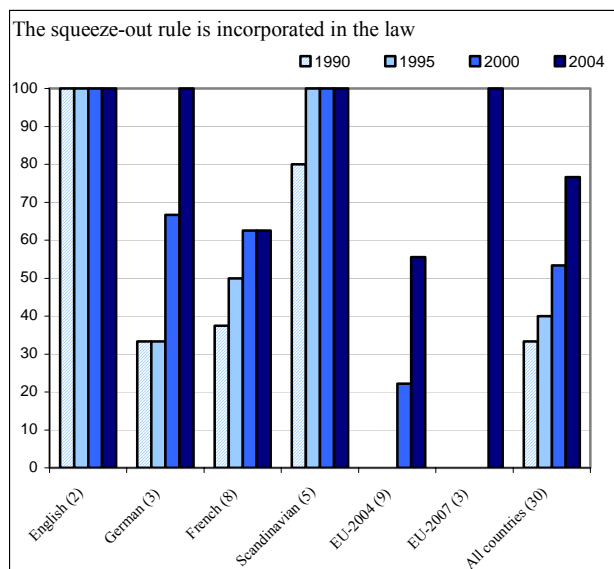


Figure 5. Adoption of the squeeze-out rule

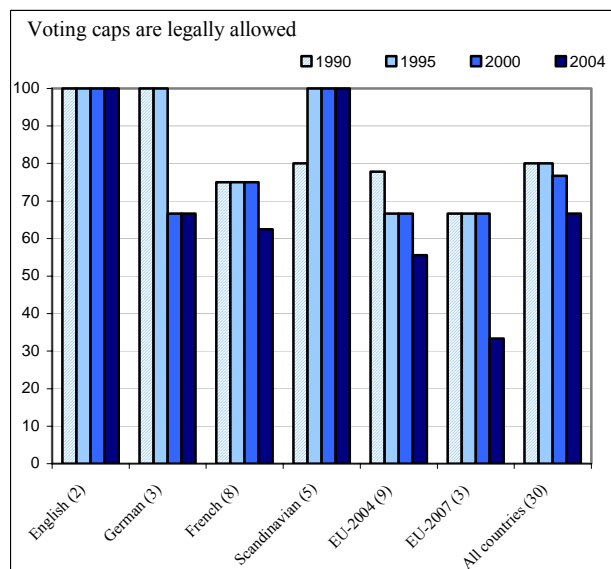


Figure 6. The use of voting caps

(See comments to the Figure 3)

Data source: Martynova and Renneboog (2004) corporate governance database.

The pan-European acceptance of the equal-treatment principle can be regarded as the result of regulatory competition between the jurisdictions. Only the central European countries were lagging but have since 2001 all adopted this principle. Under the equal-treatment requirement, countries with a low ownership threshold triggering a mandatory bid are more likely to move towards dispersed ownership than countries that make a tender offer conditional on the acquisition of control. The recent trend to reduce the mandatory bid threshold in many European countries may result in some degree of convergence towards a market-based model.

According to Figure 5, the squeeze-out provision is now commonly used in the English, German, and Scandinavian law countries. However, less than two-thirds of the French law jurisdictions had adopted the squeeze-out rule by 2004. About half the countries that joined the EU in 2004 also do not such a rule in place. However, it is likely that these countries will soon adopt the rule. As in the case of the mandatory rule, the provisions of the squeeze-out rule vary substantially across countries. Thus, the threshold beyond which a bidder can force any remaining shareholders to sell their shares ranges from 80 percent (in Ireland) to 95 percent (in Belgium, France, Germany and the Netherlands), with a threshold of 90 percent in the majority of countries. The provisions for the fixing of the price for the squeeze-out purchase also differ between the jurisdictions. Although the adoption of the squeeze-out rule may encourage more control

of shares of a public company shall be equally treated by the company". In the Czech Republic, the principle has existed since 2001 according to § 155/7 Commercial Code.

transactions, its impact on the ownership structure in countries with concentrated ownership is likely to be small, as the private benefits of holding control in these countries remain relatively high (Dyck and Zingales, 2004). To achieve ownership dispersion, the regulator needs to make control more contestable and thus combine the rule with provisions that reduce the incentives to hold controlling blocks.

An interesting result arises from the analysis of the deviation from the one-share-one-vote principle. Figures 6-8 present the evolution of the adoption or rejection of voting arrangements in the form of non-voting shares, multiple voting shares, and voting caps, respectively. Figure 6 shows the changes in the legal attitude towards voting caps. There is slow convergence towards the abolishment of voting caps. Voting caps limit the power of blockholders and may be a powerful takeover defence. Therefore, their abolishment in some European countries – such as those of French legal origin and the EU accession countries – is motivated by regulators wanting to stimulate the takeover market. However, banning voting caps in countries with concentrated ownership makes it impossible to cap the power of large new shareholders. Therefore, we project that the abolishment of voting caps in countries of French legal origin and the EU accession countries is likely to lead to even more concentrated voting power.

Most countries, with the notable exception of the Scandinavian ones, allow the issue of non-voting shares, mainly in the form of preference shares which benefit from a preferential treatment in terms of dividend payments and/or in the case of a liquidation. The shares issued by most Scandinavian companies are voting shares, although they may bear each a different number of votes. For example, the votes from B-shares in Sweden are typically one tenth of the votes from A-shares. Usually, the law restricts the issue of non-voting shares to a maximum percentage of the equity. This percentage varies from 25 to 100 percent with 50 percent in the majority of the countries. In some countries, such as the UK, corporate law does not regulate the issue of differentiated voting shares, but the London Stock Exchange has discouraged such issues. This gentlemen's agreement is well abided by as 'it is just not cricket' to issue non-voting shares (Franks, Mayer and Rossi, 2004).

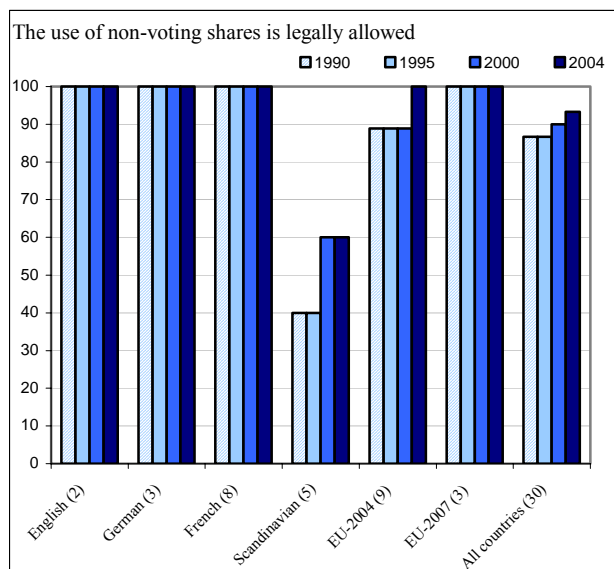


Figure 7. The use of non-voting shares

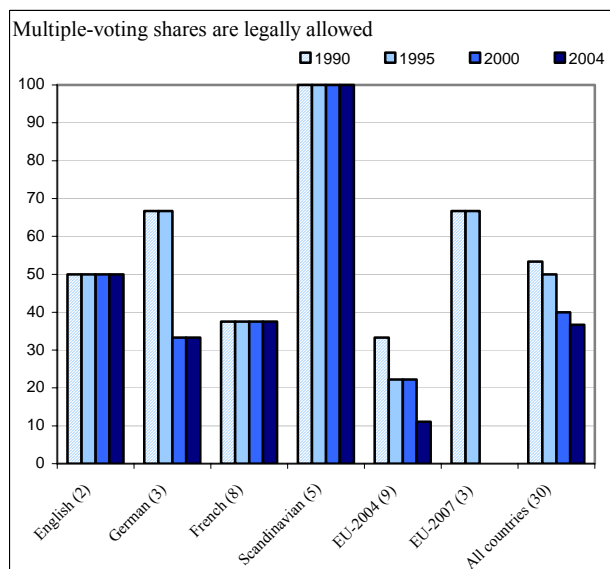


Figure 8. The use of dual-class and multiple voting shares

(See comments to the Figure 3)

Data source: Martynova and Renneboog (2004) corporate governance database.

In contrast to the wide acceptance of non-voting shares (Figure 7), the use of dual class and multiple voting shares is declining (Figure 8). By 2004 only one third of the countries allowed shares with multiple voting rights, down from more than one half in the early 1990s. This trend towards abolishing multiple voting shares may be seen as a step towards similar corporate governance practice, the development of efficient M&A market, and greater ownership dispersion in the long run.

The European Commission's proposed Takeover Directive received much resistance mainly as a consequence of the proposed break-through rule. Although Figure 9 may suggest that overall there is increasing adoption of the rule, this is mainly due to the countries that have recently joined the European Union. The only other country that has adopted the break-through rule is Italy. However, the break-through rule in Italy only applies to contractual agreements between shareholders, since shares cannot bear multiple voting rights. Pending a takeover bid, any shareholder who is willing to tender has the legal right to withdraw from voting or transfer agreements binding his shares. No minimum ownership percentage is required to qualify for this break-through rule. In addition, as outlined in sub-section 5.6, the rule may promote the creation of more complex ownership and control structures such as pyramids and cross-shareholdings thereby cancelling out most of the benefits from the break-through rule.

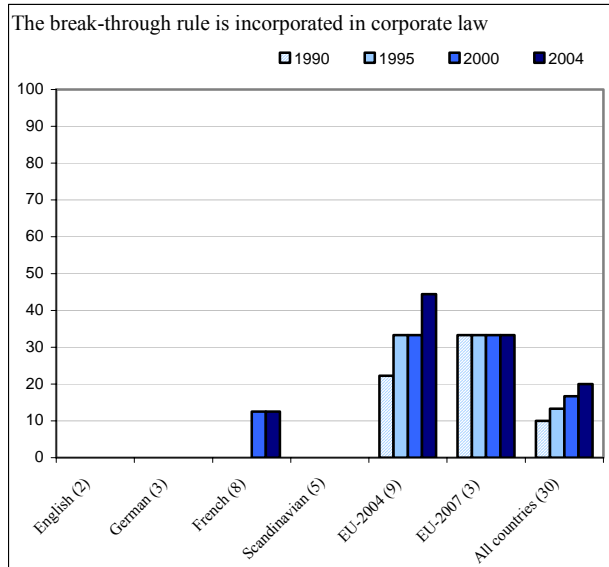


Figure 9. Adoption of the break-through rule

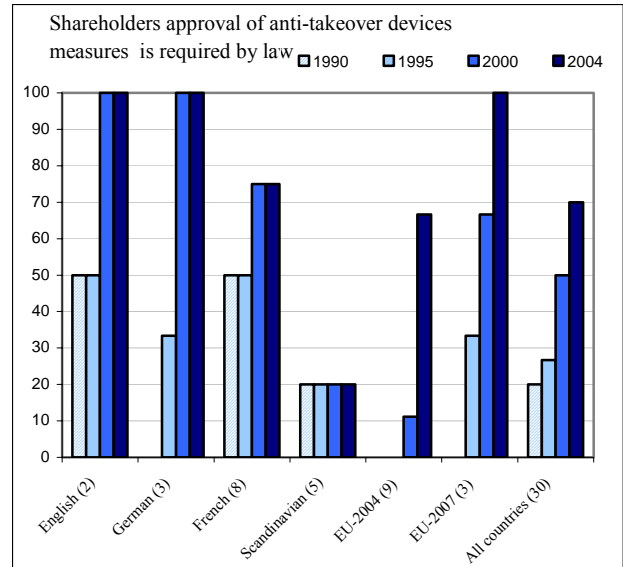


Figure 10. Adoption of the requirement of shareholders' approval to install anti-takeover measures

(See comments to the Figure 3)

Data source: Martynova and Renneboog (2004) corporate governance database.

Figure 10 refers to one of the hotly debated issues regarding the distribution of decision-making in companies, namely the adoption of anti-takeover measures. Although some countries have opted for the American-style approach by allowing managers to apply anti-takeover devices when necessary, there is a clear move in Europe towards the British model which gives decision power to the shareholders. In general, in most countries, the board of directors may only take anti-takeover measures after receiving the shareholders' approval. However, there is variation with respect to the point in time when the adoption of anti-takeover measures can be solicited. For example, shareholders in Germany can vote for defence measures prior to a takeover bid, while in the UK they can only do so after the bid has been announced. General Principle 7 of the City Code 'prohibits any action to be taken by the board of the offeree company in relation of the affairs of the offeree company, without the approval of the shareholders in general meeting'. The rule does not prohibit corporate actions which have a frustrating effect on a takeover attempt, but it does require that such actions be approved by the shareholders at a general meeting and, crucially, that the approval be given 'in the face of the bid' (Davies and Hopt (2004)). There is a trend towards reducing the power of management in takeover-related decision-making. This suggests that the shareholder-centred view of corporate governance is receiving more widespread recognition. Consequently, this may result in convergence, albeit at a very slow rate, towards the market-based model as predicted by Hansmann and Kraakman (2000).

7. Conclusion

This paper argues that the effectiveness of the various functions of the takeover regulation depend on the corporate governance systems they are part of. However, at the same time, takeover regulation also has a significant impact on the efficiency of the corporate governance system. Therefore, a regulator who wants to reform takeover regulation needs to place this reform in the wider context of reforming corporate governance as a whole. Over the past 10 years, the European Commission has attempted to harmonize takeover regulation to create a level-playing field for an international market for corporate control. These attempts have nevertheless met with strong opposition from national lawmakers arguing that a unified takeover regulation may harm their national corporate governance system. Consequently, the proposed draft for the Takeover Directive was not adopted. However, a watered down version of the original Winter proposal was adopted in April 2004.

This paper shows that, despite all the controversies, the EU countries have individually undertaken steps towards the convergence of takeover and corporate governance regulation. Currently, the European countries agree that the equal treatment rule constitutes a fundamental principle of corporate law. There is also gradual convergence towards the adoption of the mandatory bid and squeeze-out rules. The introduction of lower thresholds for the disclosure of control as well as the abolishment of multiple voting rights, while allowing non-voting shares, may also be considered as further signs of convergence towards the Anglo-American system of corporate governance.

However, it is important to note that similar regulatory changes may have very different effects within different corporate governance systems. For example, while in some countries the adoption of a specific takeover rule may lead towards more dispersed ownership, in others it may further reinforce the blockholder-based system. Moreover, there are still major differences across Europe in terms of the provisions of the mandatory bid rule (threshold and minimum offer price), the squeeze-out rule, and the distribution of the decision power between the board of directors and shareholders. Therefore, although there is some evidence of increasing convergence, this does not necessarily imply that the corporate governance regimes are truly converging towards a single system.

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Data appendix:

The Martynova-Renneboog corporate governance database comprises the main changes in corporate governance regulation in 32 European countries (including countries from Central and Eastern Europe). The database is based on the results from a questionnaire sent to legal specialists. The questionnaire is on the various aspects of the corporate governance regimes and their evolution since the early 1990s. The questionnaire contains 50 questions that cover the most important provisions of company law, stock exchange rules, bankruptcy and reorganization law at both the national and European level. In particular, the questions cover the following: (i) shareholder and creditor protection regulation, (ii) accounting standards, (iii) disclosure rules, (iv) takeover regulation (mandatory bid, squeeze-out rule, takeover defence measures, etc.), (v) insider trading regulation, (vi) regulation regarding the structure of the board of directors and voting power distribution, (vii) and adoption of codes of good practice. The names of the legal experts who contributed to this database are presented below.

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