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The Validity of Deal Protection Devices under Anglo-American Law

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GLOBAL LAW WORKING PAPER

THE VALIDITY OF DEAL PROTECTION DEVICES IN NEGOTIATED ACQUISITION OR MERGER TRANSACTIONS UNDER ANGLO-AMERICAN LAW

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THE VALIDITY OF DEAL PROTECTION DEVICES IN NEGOTIATED ACQUISITION OR MERGER TRANSACTIONS UNDER ANGLO-AMERICAN LAW

Wai Yee Wan*

ABSTRACT

This paper analyzes deal protection devices, specifically termination fees and lockup agreements, that are entered into by publicly listed target companies in favor of the bidders, under Anglo-American law. U.S. (specifically Delaware) and U.K. law and regulation differ markedly in the regulation of these devices. Delaware law generally gives more leeway for the target board to enter into deal protection devices. The U.K. regime is much more shareholder-centric and severely restricts most types of deal protections. This paper examines the differences and argues that the U.K. regime is the result of the strong influence of institutional share ownership. In contrast, in U.S., institutional share ownership is of more recent origin and market participants have instead pushed for greater board independence to counteract managerial self-interest. This paper also discusses the impact of recent trends, including changing shareholder ownership patterns and regulatory developments on the concepts of independence of outside directors and their impact on the substantive rules on deal protections. It concludes that while some modest changes to the substantive rules may be required, there is insufficient evidence to justify an overhaul of the rules in either jurisdiction.

* Global Research Fellow, NYU School of Law (Fall 2008); Assistant Professor of Law, Singapore Management University. I thank the participants of the Global Fellows Forum at NYU School of Law for their helpful comments on an earlier version of this paper, particularly Professors Jennifer Arlen and Richard Stewart.

THE VALIDITY OF DEAL PROTECTION DEVICES IN NEGOTIATED ACQUISITION OR MERGER TRANSACTIONS UNDER ANGLO-AMERICAN LAW

I. INTRODUCTION

In the United States ("U.S.") and United Kingdom ("U.K."), the strategy that is used to acquire a publicly traded corporation depends on whether the acquisition is a friendly or a hostile transaction. The majority of the corporate acquisitions are ultimately completed as friendly transactions, even though some of these transactions may originate as hostile or unsolicited transactions.[1] In friendly transactions, the target board normally recommends the approval or acceptance of the transaction with the bidder to its shareholders. Shareholders will have a right to vote on the acquisition or merger transaction or to tender their shares in the bidder's offer.

A common feature of these friendly transactions is the presence of deal protection devices granted by the target to the preferred bidder. This paper focuses on two types of such devices, namely, the termination fees, pursuant to which the target agrees to pay a fee to the preferred bidder upon a specified event which occurs that prevents the

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[1] In the years 2006 to 2008, approximately 3.8% and 4.9% of all announced M&A deals involving U.S. and U.K. target companies respectively are hostile or unsolicited. For the same period, approximately 96.5% and 86.8% of all announced M&A deals involving U.S. and U.K. target companies respectively were friendly. *See* Table 1. Source: Thomson Financial *SDC Platinum* database.

transaction from being completed, and lockups, pursuant to which the target agrees to sell either newly issued stock or its assets to the bidder, in each case, at a favorable price on the occurrence of the same event as which has triggered the payment of the termination fee. Empirical research shows that termination fees and/or lockups occur in an overwhelming majority of friendly transactions involving publicly traded companies.[2]

This paper analyzes the use of deal protection devices in negotiated merger and acquisition ("M&A") transactions in the U.S. and the U.K. involving target companies whose shares are publicly traded. U.K is chosen because like the U.S., most of its publicly traded companies have dispersed shareholdings and do not have controlling shareholders.[3] In friendly transactions found in U.S. and U.K., even though the bidder and the target may have entered into a binding acquisition agreement, the completion of the agreement is conditional upon the approval of the target shareholders. Such approvals may take several months, depending on the deal's complexity and regulatory approvals.[4]

For a target with dispersed shareholdings,[5] a bidder will often require the target to provide deal protection devices to deter subsequent bidders and to cover its expenses in the event that the transaction is not approved by target shareholders, either because there

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[2] John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 315 (2000) (reporting that in 1998, break fees were used in 70% of the friendly U.S. mergers greater than $50 million in value).

[3] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *Corporate Ownership Around the World* 54 J. FIN. 471 (1999).

[4] The average deal in the United States takes approximately five months to complete. See T.S. Walters, Alfred Yawson and Charles P.P. Yeung, *The Role of Investment Banks in M&A Transactions: Fees and Services* 16 PACIFIC BASIN FIN. J. 341, 353, tbl. 4 (2008) (showing the mean rates of completion for different classes of advisers to the target ranging from 110 to 139 days for U.S. transactions during the period 1980 to 2003).

[5] Where the target has major or significant shareholders, the acquirer may also require these shareholders to give voting undertakings. Voting undertakings by shareholders are outside the scope of this paper, since this paper is concerned with deal protection devices entered into, or granted, by the target.

is a competing bid at a higher price or because the offer price is below their expectation. A target may also grant a deal protection to a white knight bidder in response to hostile bids. The deal protection devices are normally entered into at the same time that the agreement for the merger or acquisition is signed though in certain cases, they may sometimes be entered into shortly after the signing of the agreement but before completion. Without controlling shareholders providing voting agreements in ensuring the success of the transaction, the presence of deal protections would occupy center stage in the negotiation of M&A agreements.[6] Deal protection devices are intended to be binding on the parties without the target shareholders' approval.

Deal protections can be seen as the payment of an option fee for the target or its shareholders to consider the bid. However, they can be inimical to shareholder wealth maximization as they may allow disloyal target management to use deal protection devices to entrench themselves at the expense of shareholders. Deal protection devices are also preclusive, as they discourage higher bids from being made, and thereby reducing the disciplinary effects of takeovers, raising agency problems. The academic debate pivots around the value of deal protection from an economic analysis perspective: those opposed to deal protections have sought to demonstrate the negative effects on shareholder value.[7] Those in favor have argued that they are value-enhancing as an

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[6] Deal protections are usually less significant in companies with controlling shareholders and such controlling shareholders are willing to provide undertakings to vote for the acquisition in a particular manner.

[7] *E.g.* Marcel Kahan and Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539 (1996) (examining the effect of lockups on the market for corporate control and arguing that second-bidder lockups and anticipatory lockups should not be permitted because they do not encourage competitive bidding. Only non-anticipatory first-bidder lockups should be permitted because they enhance the market for corporate control and allocational efficiency by rewarding first bidders for search costs and informational externality a bid creates); Coates and Subramanian *supra* note 2 (arguing

efficiency contracting mechanism in that they encourage bidders either to make initial bids or improve their bids.[8]

U.S. and the U.K. law and regulation restrict the ability of the target board to enter into deal protection devices. However, even though both jurisdictions regard deal protection devices as defensive measures, both jurisdictions differ markedly in the degree and substance of the regulation. The law of Delaware, which is home to approximately 50% of U.S. publicly traded companies,[9] has applied at least three standards judicial scrutiny towards the regulation of deal protections, ranging from the application of the business judgment rule, the enhanced judicial scrutiny found in *Unocal Corp. v. Mesa Petroleum Co.* ("*Unocal*"),[10] and the auction duties found in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* ("*Revlon*").[11] Even under *Revlon*, which imposes the most exacting judicial scrutiny among the three standards, the fact remains that the directors are still given considerable leeway to have a significant say in entering into the deal

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that existing theoretical models fail to take into account buy side distortions which may influence the behavior of the bidder's managers and lockups should be scrutinized more carefully because these distortions provide the opportunity for lockups to affect the allocational efficiency in the market for corporate control.)

[8] *See e.g.* Ian Ayres, *Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions*, 90 COLUM. L. REV. 682 (1990) (arguing that termination fees do not affect the outcome of bidder contests and would lead to the bidder and subsequent bidders bidding at close to their reservation prices less termination fee. However, a termination fee may preclude a higher valuing second bidder from bidding if the termination fee promised to the initial bidder is more than the difference between the initial bidder's valuation of the target and the bid price and these are known as "foreclosing lockups". However he argues that foreclosing lockups are very rare and most types of lockups should be permitted); Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739 (1994) (arguing that based on the Coarse Theorem, a termination fee will not deter a higher-valuing bidder from competing to acquire a target as long as the transaction costs for arranging a deal with the lower valuing bidder are not prohibitively higher); Brian J.M. Quinn, *Bulletproof: Mandatory Rules for Deal Protection*, 32 J. CORP. L. 865, 865-866 (2007) (arguing for a mandatory rule prohibiting sellers from providing buyers in non-*Revlon* transactions with "bullet-proof" protection, and any protection should be limited to the extent necessary to compensate bidders for the transaction and opportunity costs of making bids).

[9] Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383 (2003).

[10] 493 A.2d 946 (Del. 1985).

[11] 506 A.2d 173 (Del. 1986).

protection devices. In contrast, U.K. adopts a shareholder-centric model by having a bright line rule regulating termination fees entered into by targets. Under the City Code on Takeovers and Mergers ("Takeover Code"),[12] termination fees and lockups are prohibited once they exceed a specified, pre-determined *de minimis* threshold of 1% of the target equity value. Target equity value refers to the equity value of the target company, on a fully diluted basis.[13] Under U.K. company law, virtually all types of lockups are subject to shareholder vote, undermining the purpose of lockups as deal protections.

This paper examines the reasons for the different approaches taken in the two jurisdictions. The first is the differing impact that institutional share ownership has had on U.S. and U.K. Institutional share ownership has long been higher in the U.K. than the U.S. and such ownership had a significant impact on the development of a self-regulatory takeover regime in the U.K which promotes strict shareholder choice. A strict shareholder choice regime restricts defensive measures (including deal protections) that can be unilaterally undertaken by the target management, [14] so as to encourage more bids by bidders or potential bidders. In contrast, institutional share ownership in U.S. is comparatively of more recent origin and U.S. federal regulation has precluded the possibility of self-regulation by the institutional shareholders. Instead, institutional

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[12] THE PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS (9th ed. 2009) (U.K.) [hereinafter TAKEOVER CODE].

[13] TAKEOVER PANEL, PRACTICE STATEMENT NO. 23 of 2008, *available at* http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/ps23.pdf (last visited Jun. 1, 2009). The Takeover Panel also clarified that in calculating fully diluted basis of the equity value of the target company, only warrants and options which are in the money may be included in the calculation.

[14] *See* John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? – The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727 (2007) (arguing, in the context of explaining why U.S. and U.K. have different substantive rules on defensive measures, that the mode of regulation matters).

shareholders have pushed for boards of U.S. companies to be more independent in order to counteract managerial self-interest and to mitigate the agency problems.

The second, albeit a partial explanation, is that a bidder faces higher wasted M&A transaction costs if the deal does not go through for a U.S. transaction than for a U.K. transaction. Hence a bidder for a U.S. target has a greater incentive for demanding higher termination fees. The higher costs arise from the differences in the process of takeover regulation; the U.S. regime relies on the courts as the primary arbiter to make decisions on disputes to the takeover process and given that Anglo-American judges are reluctant to intervene in commercial decisions made by boards, the resulting case law that develops gives considerable leeway to management to enter into deal protections. In contrast, U.K. relies on the U.K. Takeover Panel ("Panel") as the final arbiter of disputes and the courts are not normally involved. Rulings are given speedily. The absence of prolonged litigation means that the takeover process is likely to be quicker and less expensive. Further, in terms of timing, a bid for a U.K. target is likely to complete within a shorter time frame than a bid for a U.S. target, which leads to costs savings. All these translate to the fact that all things being equal, the bidder's anticipated wasted M&A transactional costs would be lower in bidding for a U.S. target than for a comparable U.K. target and it has more reasons to lobby for a higher termination fee or lockup as compensation.

The recent developments on changing shareholder ownership patterns in publicly traded companies in U.S. and U.K. markets raise a couple of questions as to the likely directions in which the regulatory regimes in the two jurisdictions will move towards.

First, given that U.S. institutional share ownership is becoming more concentrated and there are signs of more shareholder activism, would U.S. move towards a strict shareholder choice system? This paper argues that it is unlikely given the history of securities law and the fact that U.S. shareholders have not actually favored a strict shareholder choice model, even when they could have done so. Instead, they have preferred to push for more independent and effective boards to safeguard their interests. Second, what are the implications for U.K, takeover regulation if its institutional share ownership is becoming more fragmented due to U.K. domestic institutions selling down U.K. equities and foreigners buying in their place? This paper argues that the strict shareholder choice regime is so deeply entrenched that it is likely to continue.

However, other trends may show that more modest changes to the substantive rules may need to be made. For example, the concept of independence and disinterestedness of outside directors in the takeover process may need to be reconsidered by the Delaware courts in view of the somewhat different concept of independence under the Sarbanes-Oxley Act ("SOX").[15] The ceiling on termination fees in U.K. may need to be reconsidered in light of the increasing use of change of control covenants in bond documentation.

Finally, this paper considers the normative implication of whether either system is preferable. This paper argues that there is no clear evidence in this regard. The U.K. system promotes more hostile bids than the U.S. but there is no clear evidence that a rule whose effects lead to more hostile bids is necessarily more welfare enhancing. Neither is

[15] Sarbanes Oxley Act of 2002 § 301 (codified at 15 U.S.C. § 78j-1(m)(3)(B)).

it clear that the U.K. system will impose more externalities for other stakeholders (such as on employees) or will be less compatible with corporate social responsibility than the U.S. The empirical studies on termination fees and lockups are also equivocal.

The analysis offered in this paper extends the prior scholarship in several ways. First, prior scholarship on deal protection devices is limited to a single country.[16] The approach in this paper is explicitly comparative. Second, the available studies in the two jurisdictions have focused on differences on regulation of hostile takeovers.[17] There is little comparative scholarship examining the issue on whether and why friendly deals selected by the target boards should be protected from third parties from a comparative perspective.[18] This paper attempts to fill the lacunae. Third, this paper identifies specific recent trends, including the changing shareholder patterns in the two jurisdictions, the increasing use of change of control clauses and the increasing emphasis placed on corporate social responsibility issues and discusses their possible impact on the substantive rules on deal protections.

This paper is organized as follows. Part II explains the nature of deal protections that are used in the M&A scene and why termination fees and lockups differ from other

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[16] E.g. Ayres, *supra* note 8; Fraidin and Hanson, *supra* note 8.

[17] *See* Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast between the United States and England*, 1998 COLUM. BUS. L. REV. 51 (1998) (examining the differences in the takeover regulation from the perspective of political choice). *See* also John Armour & David A. Skeel, Jr., *supra* note **Error! Bookmark not defined.** (examining the differences on hostile takeover regulation from the perspective of the regulatory mode in the two jurisdictions); Paul Davies & Klaus Hopt, *Control Transactions,* in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 157 (Reinier H. Kraakman *et al.* eds., 2004) [hereinafter ANATOMY OF CORPORATE LAW] (examining agency problems in change of control transactions in major representative jurisdictions including France, Germany, Japan, U.K. and U.S.).

[18] *C.f.* Heath P. Tarbet, *Merger Breakup Fees: A Critical Challenge to Anglo-American Corporate Law*, 34 LAW & POL'Y. INT'L. BUS. 627 (2003) (examining the use of termination fees in U.S. and U.K.).

types of deal protections. Part III identifies the problems that exist in M&A transactions for publicly listed companies. Part IV analyzes the differences between U.S. and U.K. approaches. Part V examines the reasons for the differences, including the different impact of institutional share ownership in the two countries. Part VI draws the matters together, and discusses the trends and implications of the foregoing analyses. Part VII concludes.

II. DEAL PROTECTIONS GENERALLY

A. *Termination Fees*

A termination fee is an arrangement between a potential acquirer and target, under which a fee is payable to the potential acquirer if a specified event occurs which prevents the transaction from completing. Termination fees are intended to operate as an incentive on the target to ensure that the transaction goes ahead as the payment of the termination fees would have lowered the value of the target.

While there is no exhaustive definition of the possible events, defined events typically include: (a) the target board withdraws its recommendation for the preferred bid; (b) the target shareholders vote down the merger or acquisition;[19] or (c) the target's recommendation or acceptance of a rival bid. At least in the U.K. context, termination fees are normally not expressed as payable upon breach of the target's obligations, as

[19] These are also known as "naked" no-vote termination fees.

they would otherwise potentially fall within the rule against penalties.[20] In situations where the parties are of a similar size or have similar bargaining power, reciprocal termination fees are not uncommon. This paper focuses only on termination fees payable by the target.

Termination fees may be expressed as fixed as one lump sum (either a fixed amount or a percentage of the transaction value). In unusual cases, agreements to pay termination fees may be entered with more than one bidder.[21] Tiered termination fees have also appeared in the market place. A tiered termination fee could be expressed as a fee payable upon the board's rejection of the bid, and a further fee payable if the target completes a transaction with another bidder within the next two years. In the last five years, go-shop provisions have started to appear and the termination fees payable are expressed in bifurcated terms. For example, for a very limited period post-signing of the merger or acquisition agreement, the target may actively solicit alternative bids. The termination fee that is payable during the go-shop period is lower than that payable after the expiry of the go-shop period but before completion.[22]

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[20] *See e.g.* Dunlop Pneumatic Tyre v. New Garage and Motor Co Ltd [1915] A.C. 79.

[21] *E.g.* in 2003, there were two rivals bids for Debenhams plc.; both of the bidders were controlled two different private equity funds, Permira and CVC Capital /Texas Pacific Group. Debenhams entered into separate agreements to pay termination fees with each of the two private equity funds, but the maximum aggregate amount that was payable under all of the arrangements was not to exceed 1% of the equity value. Debenhams agreed to pay CVC/TPG inducement fees, even after recommending Permira's bid, to encourage CVC/TPG to make a bid. See *Debenhams The,* FIN. TIMES, Sep. 13, 2003, at 16.

[22] *E.g.* in *Re Topps Co. Shareholders' Litigation*, 926 A.2d 58 (Del. Ch. 2007) (containing an agreement that if the target terminated the merger agreement to accept a superior proposal during the go-shop period, the target had to pay $8 million fee plus $3.5 million in expenses (representing in total 3% of the deal value), and if the target terminated the agreement after the go-shop period, it had to pay $12 million plus $4.6 million in expenses (representing in total 4.6% of the deal value)).

The Takeover Code only allows the target to agree to a termination fee with a bidder which represents a maximum of 1% of the target equity value based on the offer price.[23] The implication is that the out of pocket costs incurred by a bidder for a U.K. target would not normally exceed 1% of the equity value. [24] In contrast, termination fees in the U.S. are higher, which can be up to 6% of the deal value.[25] The Delaware courts have allowed inducement fees of a magnitude of up to approximately 5% of the equity value.[26] Also in many cases, merger agreements have separate clauses requiring compensation for the preferred bidder's actual and documented costs, which are in addition to the termination fees.[27]

B. *Lockups*

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[23] The Takeover Panel has clarified that the target may enter into separate agreements to pay termination fees with two or more offerors, in each case up to 1% of the target equity value, even though the aggregate amount may exceed 1%. See TAKEOVER PANEL, PRACTICE STATEMENT NO. 23 OF 2008, *supra* note 13.

[24] *Infra* note 165; s*ee also* Alan Gregory, *Discussion of Termination Fees in Mergers and Acquisitions: Protecting Investors or Managers*, 34 J. BUS. FIN. & ACC. 541 (2007) (discussing the likely out of pocket costs incurred in connection with a U.K. transaction and arguing that it is unlikely for such costs to exceed 1% of equity value save in exceptional circumstances such as the transaction complexity or the low value of the bid). The point by Alan Gregory may be illustrated in the bid by Morgan Stanley for Canary Wharf in 2003, where the termination fee was structured as follows: (1) £15.5 million, representing approximately 1% of the deal value, payable if independent directors withdraw or adversely modify the recommendation; and (2) £7.8 million, representing approximately 0.5% of the deal value, if the transaction is unsuccessful for any other reason. The lower figure in (2) suggests that the intention is to cover the bidder's costs. See Jenny Davey, *Morgan Stanley offered £7.8m fee if Canary bid fails*, TIMES (LONDON), Dec. 6, 2003 at 54 and Canary Wharf Group plc, RECOMMENDED OFFER BY SILVESTER UK PROPERTIES LIMITED FOR CANARY WHARF GROUP PLC, Jan. 15, 2004, 26 (copy on file with author).

[25] *See* Coates and Subramanian, *supra* note 2 at 346.

[26] *E.g.* McMillan v. Intercargo Corp. 768 A.2d 492 (Del. 2000) (upholding fee of 3.5% of target equity value); Kysor Indust. Corp v. Margaux, Inc. 674 A.2d 889 (Del. 1996) (upholding a fee that was computed as high as 4.8% of the deal price); In re Pennaco Energy, Inc. 787 A.2d. 691 (Del. Ch. 2001) (upholding termination fee of 3% and matching rights); In Re Toys "R" Us, Inc., Shareholder Litigation 877 A.2d 975 (2005) (upholding termination fee that was 3.75% of equity value or 3.25% of transaction value). C*.f.* Phelps Dodge Corp. v. Cyprus Amax Minerals Co., 1999 WL 1054255 (Del Ch. 1999) (indicating that a termination fee of 6.3% certainly "seems to stretch the definition of the range of reasonableness and probably stretches the definition beyond its breaking point").

[27] *E.g.* In *Re Toys "R" Us*, *id.*, (the fee was expressed as payable: (1) $247.5 million (representing 3.75% of the equity value of the target) if the target terminated the agreement and signed up with another acquisition partner within a year; and (2) up to $30 million in documented expenses (representing 0.5% of the equity value of the target) if the shareholders vote down the proposal).

Under a stock lockup, the target grants the bidder a stock option, which is normally exercisable in the event that the target decides to terminate the merger agreement to merge with a third party or where a person (other than the bidder) ends up holding a specified percentage of the target. An additional feature of a stock lockup includes allowing the holder to put the lockup to the target in exchange for cash payments.[28] The stock lockup thus increases the cost of a potential second bidder which wishes to interlope. An asset lockup gives the bidder the opportunity to purchase specified assets of the potential merger partner at an attractive price if the deal breaks down. [29] It makes deal-jumping unprofitable for the deserting partner and causes other potential bidders to lose interest.

In the U.S., typically the stock lockup for newly issued shares will not exceed 20% of the target's existing shares as many exchanges will require shareholder approval.[30] Stock lockups granted by the target normally do not go so far as to permit the bidder to exercise the option prior to the shareholders' meeting so as to vote those shares in favor of the transaction at such meeting.[31] With the abolishment of pooling of interests

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[28] Many of these stock lockups are capped, after Paramount v. QVC Paramount Communication Inc. 637 A.2d 34 (Del. 1994) where the Delaware Supreme Court criticized the use of the uncapped lockup.

[29] It has been reported that asset lockups are virtually extinct by the late 1990s after Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. 506 A.2d 173 (Del. 1986). and Mills Acquisition v. MacMillan Inc 559 A. 2d 1261 (Del 1989). See Coates & Subramanian, *supra* note 2, at 327.

[30] The rules of the New York Stock Exchange, the American Stock Exchange and Nasdaq require shareholder approval for issuance of more than 20% of the corporation's shares.

[31] However, in the recent Bear Stearns/ JP Morgan Chase merger in 2008 which arose in the pending insolvency of Bear Stearns. In connection with JP Morgan Chase's acquisition of Bear Stearns effected by way of a merger, JP Morgan acquired new shares in the target (issued by the board), amounting to 39.5% of its outstanding common stock after the issuance, in advance of the Bear Stearns' shareholder vote and voted such shares at the meeting. See Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 of The Bear Stearns Companies Inc., Apr. 28, 2008, 1. See also Marcel Kahan and

accounting treatment in 2001 in U.S., there is less incentive to undertake a stock lockup.[32] In comparison, asset and stock lockups are rarely used in the U.K. for the reasons set out in Part IV(A) below.

C. *Distinction between Termination Fees, Lockups and other Deal Protection Devices ("Embedded" versus "Pure" Deal Protections)*

Termination fees and lockups raise unique issues compared to other types of deal protections. Termination fees result in an immediate reduction in the value the target should the target not consummate the deal with the preferred bidder. Lockups have the tendency to do the same in the instances where the lockups have been granted to the preferred bidder at favorable prices. However, they also serve to compensate the bidder, to varying extents, if the target chooses not to consummate the deal. They are regarded as "embedded" deal protections for the purpose of this paper.[33]

In contrast, other alternative deal protections, such as the exclusivity (in the form of no-shop or no-talk) and the mandatory recommendation provisions, do not reduce the value of the target. However, they are regarded to be even more pernicious in other ways. For instance, no-shop provisions typically prevent the target board from soliciting alternative bids once the merger or acquisition agreement is signed. No-talk provisions

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Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware and the Strategic Use of Comity*, 58 EMORY L.J. 713 (2009).

[32] Prior to June 2001, a stock option is used to destroy the pooling of interests accounting treatment for a competitive bidder. However, this accounting treatment ended in June 2001, and hence ending the incentive to use stock lockups. See Martin Lipton & Erica H. Steinberger, *Takeovers & Freezeouts*, § 5A.03[1], 5A.03[2] (2002).

[33] The term is adapted from the term "embedded defenses", that was first coined in Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 594 (2003).

are more severe than no-shop provisions, in that they prohibit the target board from entertaining requests for negotiation or information with alternative bidders. Severe no-talk and no-shop provisions prevent the target from negotiating or even responding to requests for information alternative bidders, with the result that such offers may not even be brought to the shareholders of the target.[34]

Mandatory recommendation provisions require the target board to put forth, and recommend, the deal with the bidder to the target shareholders. From the bidder's perspective, exclusivity and mandatory recommendations are "pure" deal protections because they are adopted for the sole purpose of preventing the target company from consummating any other alternative deal. Both U.K. and Delaware law subject the "pure" deal protections of exclusivity and mandatory recommendations to the directors' fiduciary obligations. In U.K., an agreement requiring the target board to recommend the preferred bid to the shareholders is subject to the implied term that such agreement ceases once there is a better offer and the directors are of the view that they are no longer able to bona fide recommend the offer.[35] Similarly the Delaware courts have held that strict exclusivity provisions are pernicious[36] and mandatory recommendation provisions violate the prohibition, which is derived under § 141(a) of the DGCL, against contractual

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[34] One additional form of deal protection that is a hybrid between mandatory recommendation and exclusivity provision is the matching rights. A matching right operates as rights of first refusal; in the event that a subsequent bid is made, the initial bidder has the right to match the subsequent bidder's bid by purchasing on the same terms as those offered by the subsequent bidder. Often a matching right is accompanied by a provision which prevents the target board from changing the recommendation if the bidder exercises its matching right. Matching rights serve as a disincentive for the subsequent bidder to make a bid because it could incur all the expenses of the bid, only to find that the initial bidder exercises its right of first refusal and walk away of the target. It is not clear if matching rights without a fiduciary out will survive judicial scrutiny. *C.f.* Toys "R" Us, Inc., Shareholder Litig. 877 A 2d 975, 1021 (Del Ch 2005), which had a termination fee combined with a right of first refusal, which was upheld.

[35] Dawson International plc. v. Coats Patons plc. [1988] 4 B.C.C. 305.

[36] ACE Ltd v. Capital Re Corp., 747 A.2d 95 (Del. 1999); Phelps Dodge Corporation v. Cyprus Amax Minerals Company, 1999 Del. Ch. LEXIS 202, WL 1054255.

arrangements that fetter the board's discretion.[37] Accordingly, these provisions are subject to the fiduciary-out. The result of the fiduciary out is to enable targets to accept alternative competing bids or to compel the renegotiation of the price.

However, the solution of subjecting exclusivity and mandatory recommendations to a fiduciary out does not work for termination fees and lockups. The whole purpose of termination fees and lockup agreements is that the bidder wants to be financially compensated if its deal is not consummated and to deter rival bids. Subjecting these deal protections to the fiduciary-out would render the deal protections nugatory.

III. THE PROBLEMS WITH DEAL PROTECTIONS

A. *The Temporal Gap between Signing and Completion and Asymmetry between Bidder and Target Regarding Deal Certainty*

Under the takeover law and regulation in U.K. and Delaware, once the bidder and target have entered into a binding merger or acquisition agreement or once the bidder has announced the offer, the merger or acquisition is always conditional upon target shareholder approval, either by shareholder vote or by the tendering of their shares. In a friendly transaction involving Delaware corporations, the transaction may be structured as a merger under § 251 of the Delaware General Corporation Law ("DGCL") or a

[37] Paramount Communication Inc. v. QVC Network, Inc. 637 A.2d 34 (Del. 1994); CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008).

recommended tender offer followed by a freeze-out merger.[38] For the former, the transaction requires the approval by a majority of the outstanding shares.[39] For the latter, the offer is made by the bidder to the shareholders and the target board agrees to recommend to the shareholders that they tender their shares under the tender offer. The tender offer is required to be open for at least 20 business days.[40] To achieve such approval either by shareholder vote or by tender, the requisite disclosures in the form of a proxy statement[41] (for merger) or a tender offer statement[42] must be prepared and filed with the U.S. Securities and Exchange Commission ("SEC").

Similarly, in the case of U.K. companies, a friendly transaction can be structured as a scheme of arrangement under Part 26 of the Companies Act 2006 ("Companies Act")[43] or a recommended offer for the target shares. A scheme of arrangement requires the target board to propose the scheme to its shareholders and approval by a majority in number representing 75% in value of the shareholders, present and voting, either in person or by proxy, at the court-sanctioned meeting.[44] For an offer for the target shares, the offer is required to be open for at least 21 days from the date the offer document is posted.[45] A scheme document (for a scheme of arrangement)[46] and an offer document (for

38 It is also possible to purchase the assets of the target but this is not considered in this paper as it does not involve the acquisition of shares of target and the ownership structure of target remains the same post transaction.
39 DEL. CODE ANN. Tit. 8 § 251.
40 17 C.F.R. § 240.14e-1 (2003).
41 17 C.F.R. § 240.14a-3(a) (2003).
42 17 C.F.R. § 240.14d-2(b) (2003).
43 Companies Act, 2006, c. 46 (Eng.) [hereinafter COMPANIES ACT].
44 Companies Act, § 899.
45 TAKEOVER CODE, Rule 31.1.
46 Companies Act, § 897.

an offer) [47] must be dispatched to the shareholders under the Companies Act and the Takeover Code respectively.

In contrast, even though the parties may agree otherwise, the acquirer is normally absolutely bound by the merger or acquisition agreement. The acquirer can only terminate the agreement only in exogenous circumstances.[48]

Faced with the prospect that a competing bidder may emerge after announcement but before completion, the bidder will want to reduce the risk of the target not completing the deal. The bidder would have incurred the costs of bidding, including the out of pocket costs (costs of negotiation, hiring the accountants, bankers and lawyers to conduct due diligence and banking financing costs) and other costs (including diversion from managing the business and the costs of exploring other merger or acquisition alternatives). Further, if the bidder is a publicly traded entity and has publicly disclosed the virtues of the merger, the bidder may suffer a fall in its stock value if the deal is pulled.

The bidder has limited methods of protecting itself. It can require the target to agree to an exclusivity agreement. However, such an agreement is inevitably subject to a fiduciary-out, making it ineffective as a deal protection.[49] Alternatively, the bidder can

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[47] TAKEOVER CODE, Rule 24.

[48] In the U.K., there are severe limits on when the acquirer may lapse an offer once an offer is announced on grounds other than the non-fulfillment of the acceptance condition. It can only do so if the circumstances that give to the invocation of the condition are of material significance to the offeror in the context of the offer. See TAKEOVER CODE, Rule 13.4.

[49] *Supra* Part II(C).

purchase target shares prior to making a bid. This is also known as toehold purchases. Functionally, they operate as stock lockups though the important difference is that a bidder can do so without the relevant target's involvement.[50] However, they are much more expensive than stock lockups.[51] In addition, § 203 of the DGCL prohibits any business combination between the bidder and the target company for a period of three years after the bidder passes the 15% threshold unless post-completion, unless the bidder receives board approval and two-third approval from the minority who remained after the takeover.[52] Hence, if the bidder is not able to obtain approval of the target board post-acquisition, the bidder will effectively need to wait out three years before it can exercise its ability to squeeze out minority ownership through a short form or long form merger. Also the requirement that public disclosure be made of holdings of significant stakes limits the opportunity to make inexpensive purchases. Section 13(d) of the Securities Exchange Act 1934 requires disclosure by 5% shareholders.[53] Its equivalent U.K. counterpart is the requirement which requires the disclosure of shareholdings of 3% or more.[54]

Further, in the U.K., toehold purchases run the additional complication that they impact the actual offer to be made by the bidder in many respects not found in a U.S. transaction. For example, share purchases affect the price at which the shares may be

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[50] Coates and Subramanian, *supra*, note 2, 350.

[51] Timothy R. Burch, *Locking up Rival Bidders: The Use of Lockup Options in Corporate Mergers,* 60 J. FIN. ECON. 103 (2001).

[52] DEL. CODE ANN. Tit. 8 § 203. The prohibition does not apply if the takeover is approved by the board of the target before the bidder crosses 15% threshold or the bidder moves from below 15% to 85% in a single tender offer, excluding inside director shares.

[53] 15 U.S.C. § 78m(d).

[54] FINANCIAL SERVICES AUTHORITY, FSA HANDBOOK, DISCLOSURE RULES AND TRANSPARENCY RULES, D.T.R. 5.

acquired under the offer. Target shares held by the bidder generally cannot be voted at the scheme meetings if the takeover is implemented by means of a scheme of arrangement under the Companies Act.[55] These shares will also not be counted towards achieving the compulsory acquisition threshold if the acquisition is effected by means of a general offer.[56]

Thus, from the bidder's perspective, the termination fee or the lockup is more effective in protecting its interests than other types of deal protections. Limiting the bidder's ability to demand for a termination fee or lockup will reduce its willingness to make bids and if a bid is made, the bidder will offer a lower price than it would if a termination fee or lockup was available.

B. *The Agency Problem*

Where shareholdings are dispersed in a corporation, the agency problem becomes acute.[57] From an economic perspective, when one person (the principal) depends upon another (the agent), an agency relationship arises. When agents engage in activities on behalf of their principals, they are tempted to put their own interests first, resulting in agency costs. Self-serving managerial conduct creates agency costs for shareholders. By liberally allowing deal protections, disloyal managers of a target may then be allowed to

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[55] Re Hellenic & General Trust [1976] 1 W.L.R. 123 (Ch.D.); Re BTR plc [2000] 1 B.C.L.C. 740. *See* Wai Y. Wan, *Effecting Compulsory Acquisition via the Amalgamation Process* [2007] Sing. J.L.S. 323, at 333-335.

[56] Companies Act, §§ 974-975.

[57] *See* Henry Hansmann and Reinier Kraakman, *Agency Problems and Legal Strategies,* in ANATOMY OF CORPORATE LAW , *supra* note 17 at 164.

grant termination fees or lockups to a favored bidder who has offered side deals to the managers. These side deals may include additional parachute provisions[58] or management positions in the continuing merged entity. The shareholders of the target will not be able to take advantage of these benefits. This is part of a larger agency problem that exists between shareholders and the target management. There are some empirical studies to show that agency costs are significant in negotiated M&A transaction.[59]

The agency problem is compounded by the fact that takeovers and mergers are "last period" transactions. In ordinary times, managers are incentivized by the firm's policies on rewarding achievements through compensation and are disciplined through dismissal or demotion. Sean Griffith argues that the managers are ordinarily subject to constraints.[60] When agents fear themselves to be in the last period of employment, these constraints imposed on the target management ceases; when the management has lost control, they no longer see the company's products as being their responsibilities.

Unlike certain types of defensive measures such as poison pills and selective payments to green-mailers,[61] deal protections granted generally do not exist solely as

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[58] Parachute provisions only apply to U.S. deals. In the U.K., Companies Act, §§ 216 to 219 require shareholder approval for payments made to directors by way of compensation for loss of office post-takeover.

[59] For instance, a study by Julie Wulf indicates that CEOs are willing to forego higher premia in exchange for better managerial position in the merged entity. *See* Julie Wulf, *Do CEOs in Mergers Trade Power for Premium? Evidence from 'Mergers of Equals'*, 20 J.L. ECON. & ORG. 60, 87 (2004). A study by Hartzell, Ofek & Yermack indicates that target CEOs accept lower premia in exchange of special personal treatments. *See* Jay C. Hartzell, Eli Ofek and David Yermack, *What's in It for Me? CEOs Whose Firms are Acquired*, 17 REV. FIN. STUD. 37, 57 (2004).

[60] *See* Sean L. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899 (2002).

[61] Selective treatment to shareholders under a discriminatory self-tender of shares is no longer permissible: Rule 13e-4; 17 C.F.R. § 240.13e-4.

defensive measures adopted for the sole purpose of deterring hostile bids but are often justified as serving legitimate business purposes, making it difficult to isolate the purpose for such measures being taken. A legitimate business purpose includes the fact that the initial bidder or the white knight bidder may not come forward with a bid unless he is granted a termination fee or a lockup. In addition, it could be argued that management has better insight on the company's long-term outlook and growth. In order to credibly negotiate better deals, they would need to be able to offer termination fees and lockups.

Hence, despite the agency problem created by deal protections between shareholders and management, shareholders may be willing to live with deal protections as being necessary in any system of regulation that enhances competing bids. If deal protections are prohibited, initial bidders will be discouraged from making bids in the first place since the empirical evidence is that first bidders often lose out when competitors emerge.[62] If initial bids are discouraged, then the disciplinary effect of takeovers will be reduced.

IV. THE TWO DIFFERENT SYSTEMS OF REGULATION – COMPARISON AND EVALUATION

A. *U.K. Approach*

U.K. takeover law and regulation is largely found in the Takeover Code, with the Companies Act, the Financial Services and Markets Act of 2000, and regulations

[62] Richard S. Ruback, *Assessing competition in the Market for Corporate Acquisitions* 11 J. FIN. ECON. 141 (1983).

promulgated under those legislation playing supplementary roles. The Takeover Code[63] first came into effect in 1968 as a response to the market abuses in the 1950s and 1960s.[64] When it was promulgated, the Takeover Code did not have the force of law. Instead, the Takeover Code was enforced by the Panel and was part of a self-regulatory system in which bodies that represent market participants appoint the members of the Panel. The Panel's regulatory powers included the powers of administering, monitoring, compliance with and enforcing the detailed rules and principles in, and granting dispensations from, the Takeover Code. Enforcement was done through censures and the withholding of market facilities to the contravening persons.

In 2004, the European Takeover Directive[65] was adopted and the Government placed the Takeover Code on a statutory footing by enacting provisions to the effect in the Companies Act.[66] However, the legislation did not fundamentally change the way that the Panel worked and maintained the advantages of a self-regulatory approach.[67] Currently, in addition to censure or taking action for the purpose of withdrawing facilities to contravening persons, the Panel may apply to the court to secure enforcement of the Takeover Code.[68] The Panel also can report the offending conduct to regulatory bodies

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[63] For a full account of the history and development of the TAKEOVER CODE, see Andrew Johnston, *Takeover Regulation: Historical and Theoretical Perspectives on the City Code* 66 CAMBRIDGE L.J. 422 (2007).

[64] *Infra* notes 133-134 and accompanying text.

[65] European Parliament and Council Directive 2004/25, 2004 O.J. (L142) 12 (EC).

[66] Companies Act, § 942.

[67] See Jonathan Mukwiri, *The Myth of Tactical Litigation in UK Takeovers*, 8 J. CORP. L. STUD. 373 (2008).

[68] Takeovers Directives (Interim Implementation) Regulations 2006, Reg. 11.

with statutory powers such as the Financial Services Authority who can take the relevant enforcement action.[69]

Strict Shareholder choice

A fundamental objective of the Takeover Code is to ensure that shareholders have the right to determine the merits of the offer.[70] Boards of target companies are prohibited from taking any action that would frustrate an offer or potential offer[71] without the prior approval of shareholders.[72] Even though the Takeover Code has been amended several times since its promulgation in 1968, this prohibition on frustrating actions by the target board has remained unchanged. The following rules illustrate the application of the basic prohibition for target managers to take any action that may frustrate a *bona fide* hostile bid in the absence of shareholder approval in the context of deal protections.

First, deal protection devices with favored bidders are regarded as having effects that frustrate other potential offers. Under Rule 21.2 of the Takeover Code, termination fees (also known as inducement fees) are only allowed by the Panel if the following requirements are met: (a) the termination fee does not exceed 1% of the equity value of

[69] TAKEOVER CODE, Introduction, para. 11(b)(iv).

[70] TAKEOVER CODE, General Principle 3, at B1 (providing that "[t]he 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 offer").

[71] TAKEOVER CODE, Introduction, para. 3(b) (providing that the TAKEOVER CODE applies to transactions for companies subject to the TAKEOVER CODE at whatever stage of their implementation, including possible transactions which have not yet been announced).

[72] TAKEOVER CODE, Rule 21.

the target, based on the offer price;[73] and (b) the board of the target and its financial adviser confirm to the Panel in writing that they each believe the fee to be in the interests of the target shareholders.[74] The Takeover Code expressly provides that it does not affect the analysis on the common law obligations owed by the directors to the target.[75]

Rule 21.2 is designed to eschew a formalistic effect; even contractual agreements providing for sums payable upon a breach of the merger agreement which prevent the offer from proceeding or causing the offer to fail will be subject to the 1% cap. Lockups which enable assets or shares to be purchased upon the preferred bidder's offer failing are expressly caught within the prohibition under Rule 21.2 of the Takeover Code. [76]

A shareholder-centric view adopted by the Takeover Code does not mean that target directors are entirely passive in the takeover process; target directors are required

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[73] TAKEOVER CODE, PRACTICE STATEMENT NO. 23 OF 2008 (indicating that the Panel would look at the substance of the termination fee; any fee that is payable which has similar or comparable financial impact as the termination fee will fall within Rule 21.2).

[74] The other requirements include full disclosure of the termination fee and prior consultation with the Panel.

[75] TAKEOVER CODE, Rule 21 expressly provides that the views of the Panel only relate to the TAKEOVER CODE.

[76] The example given in the TAKEOVER CODE was where Company A and Company B entered into a commercial joint venture which enabled Company B to acquire Company A's interest in the joint venture at a discount in the event of a change of control of Company A; such a discount would be limited under Rule 21.2. This example is likely to be drawn from the merger transaction between P&O Princess and Royal Caribbean in 2002, where both P&O Princess and Royal Caribbean entered into a joint venture agreement contemporaneously with the implementation agreement to merge by way of a dual listed structure. Under the joint venture agreement, each party committed to contribute to US$500 million to the joint venture company, and upon change of control of either company, such company will be subject to put and call arrangements. This put and call arrangement will make it more costly indirectly for a potential bidder (Carnival) to acquire the shares in P&O Princess, as upon the completion of such an acquisition which would trigger the change in control of P&O Princess, P&O Princess will be subject to the put and call arrangements in relation to the joint venture agreement. The value of P&O Princess would correspondingly decrease by reason of the payment required to be made by P&O Princess under the put and call arrangements.

to state their views on the bid to the shareholders,[77] which ensures that shareholders will have the information that they need in order to determine whether to accept the bid. In certain situations, the support of target directors is crucial. For example, if the bidder wishes to structure the merger or acquisition as a scheme of arrangement (as opposed to a takeover) because of the more favorable rules to achieve 100% control of the target, the target board support is essential as the board must put the transaction before the shareholders.[78] This is the case even if the major or controlling shareholders wish to effect the transaction via a scheme of arrangement with the bidder but the transaction is opposed by the board.[79]

The Takeover Code is only applicable where there is a bid or the possibility of a bid.[80] However, other parts of U.K. company law and U.K. Listing Rules[81] place restrictions on the board of a publicly traded company to undertake pre-bid defenses in the absence of a contemporaneous shareholder approval. The requirement of shareholder approvals under the Companies Act and the U.K. Listing Rules in a number of corporate actions (including share issuance) make it difficult for the target board to unilaterally implement defensive measures without shareholder sanctions. In effect, these rules make

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77 TAKEOVER CODE, Rule 25.1.

78 If the bidder desires to obtain 100% control of the target, it can structure the takeover to be implemented by a scheme of arrangement (which requires approval by a majority of shareholders in number representing 75% in value of the shares) or a general offer followed by the compulsory acquisition process (which requires 90% of the shares being tendered into the offer).

79 In re Re Savoy Ltd. [1981] Ch. 351.

80 TAKEOVER CODE, Introduction, para 3(b).

81 FINANCIAL SERVICES AUTHORITY, FSA HANDBOOK: LISTING RULESS (U.K.), http://fsahandbook.info/FSA/html/handbook/LR [hereinafter U.K. LISTING RULES]

it more difficult for the target board to erect takeover defenses favoring the preferred bidder even in the absence of a bid. The following elaborates.[82]

First, even if a stock lockup falls within the constraints of Rule 21.2 (that is, the value of the stock lockup is below the 1% target equity value cap), the Companies Act requires prior shareholder approval for the board to issue new shares or to grant option to subscribe for shares in the company.[83] Existing shareholders of target also have rights of pre-emption in relation to the issuance for cash of equity securities or rights to subscribe for equity securities subject to limited exceptions.[84] While the Companies Act enables directors to obtain advance approval from the shareholders to issue shares and have the pre-emption rights disapplied for periods, in each case, of up to five years,[85] in practice, due to the influence of institutional shareholders, the directors will not be able to obtain the full approval permitted under the legislation. Instead, the directors will only obtain approval for issuance of not more than 5% of the issued share capital of the company in any one year for a non-routine rights issue and any such authority granted will have

[82] One further issue that has received some attention is whether break fees constitute prohibited financial assistance under the Companies Act, §§ 667, 668 and 680. Generally, under the aforementioned provisions, public companies are prohibited offering financial assistance to bidders for the acquisition of their own shares, unless an exception applies. Although it has been argued that termination fees and their functional equivalents may be regarded as providing financial assistance to the bidders to assist them indirectly in the acquisition of their own share, the better view is that break fees do not constitute financial assistance either because it is not "assistance" but merely an inducement fee, or a break fee is only payable if an acquisition, a necessary element of the offence does not occur. *See* Brigid Breslin and William Charnley, *Break Fees: Financial Assistance and Directors' Duties*, 21 COMPANY LAWYER 296 (2000).

[83] Companies Act, § 551.

[84] Companies Act, § 561. Under the pre-emption rights, the issuance for cash for equity securities or rights to subscribe for equity securities must be offered first to the existing equity shareholders in proportion to the respective shareholdings, unless a special resolution to the contrary has been passed by shareholders in general meeting under § 571. An issue of shares or option grant in consideration for a reciprocal issue of shares or option should not constitute an issue for cash.

[85] Companies Act 2006, § 571 read with §§ 561 and 551.

limited validity for not more than 15 months or until the next annual general meeting, whichever is the shorter period.[86]

Second, apart from the above requirement for shareholders' approval for any share issuance, the grant of a stock or asset lockup may require prior shareholder approval under Chapter 10 of the U.K. Listing Rules,[87] depending on the size of the transaction and the consideration that is involved. In summary, in a transaction where any percentage ratio (based on gross assets, profits, consideration and gross capital tests) is 25% or more, shareholder approval is required. The U.K. Listing Rules provide that a termination fee that exceeds 1% of the value of the publicly traded company calculated by reference to the offer price requires shareholder approval.[88]

Third, the Companies Act places severe restrictions on the circumstances in which payments may be made to a director for loss of office (which includes the loss of employment) upon the takeover without shareholder approval.[89] Such payments are regarded as either influencing the director's recommendation or benefitting the director at the expense of the shareholders. No comparable restrictions are found under Delaware law.

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86 *See infra* note 141 and accompanying text.

87 U.K. LISTING RULES, Rule 10.1.

88 U.K. LISTING RULES, Rule 10.2.7.

89 Companies Act, § 217 read with § 215. Note, however, these restrictions do not cover payments made in discharge of existing legal obligations which are not entered into in connection with the takeover. Hence the vesting of employee options upon change of control will not be subject to such restrictions if these options are granted well in advance of the takeover.

In contrast to the Takeover Code, U.K. case law on fiduciary standards allows more scope for directors to adopt defensive measures. Unlike Delaware corporate law, the U.K. does not have the equivalent of the formal business judgment rule. Instead, the English courts have developed the doctrine that the actions of the management must be for a proper purpose. Under this doctrine, as exemplified in *Hogg v. Cramphorn Ltd.*[90] and *Howard Smith v. Ampol Petroleum*,[91] the court must determine the purpose for which management decision is undertaken. A decision of the board whose primary purpose is improper, such as to frustrate an unwelcome bid or ensuring their preferred bid is successful, is regarded as a breach of duty. However, dicta in the case law also suggests that if the board *bona fide* believes that the decision (even if it is a decision affecting the change of control) is in the interest of the company, the court will not intervene to substitute its decision for the board.[92]

The proper purpose rule is now codified in s 171 of the Companies Act, which requires the directors of a company to exercise their powers for a proper purpose. It has not been decided by the English courts as to whether a company which enters into a deal

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90 [1967] 1 Ch. 254.

91 In a slightly different context, the court had to consider whether a poison pill taken by the directors is consistent with the proper purpose rule. In Criterion Properties Plc v. Stratford UK Properties LLC [2004] U.K.H.L. 28, the defendant, a joint venture partner, was given an option to be bought out upon favorable terms upon there being a change of control or the departure by certain senior management of the claimant. One year later, the senior management of the claimant left the company and the defendant sought to enforce the option agreement. It was argued that the option agreement was entered into to fend off an unwanted predator. At first instance, it was held that the option agreement was entered into by the directors of the claimant for an improper purpose. However, this point was not specifically decided by the Court of Appeal or the House of Lords. The Court of Appeal agreed on the abuse of power, but held on the narrower ground that the option agreement was much wider than fending off the predator; it could apply when there was a change of control or departure of certain officials and invalidated the option. The decision was reversed by the House of Lords on a different point, that is, it was not determined whether the claimant company had authority to enter into the option agreement.

92 *E.g.* Cayne and Munro Bank v. Global Natural Resources plc., per Sir Meggary VC, Ch. Aug. 12, 1982 (unreported), aff'd [1984] 1 All E.R. 225.

protection device to ensure the success of a preferred bid is consistent with the proper purpose rule [93] and there is a dearth of case law in this area. The likely explanation of the absence of case law is that in relation to post-bid defenses, the position is subsumed under Rule 21 of the Takeover Code. Rule 21 does not focus on the purpose of the directors' actions (which requires a fact intensive inquiry), but whether the consequences of such actions have the effect of frustrating a bona fide bid. Hence, the Takeover Code is a much more powerful tool in regulating post-bid conduct, and subsumes the development of the case law.

B. *U.S. (Delaware) Approach*

U.S. takeovers are regulated at the federal level since 1930s by the enactment of the Securities Act of 1933,[94] Securities Exchange Act of 1934[95] (as amended by the Williams Act[96]) and the SEC rules promulgated thereunder, and at the state level, state legislation and case law. U.S. law (specifically Delaware law) gives considerable leeway to the management of target companies to have a significant role in accepting or rejecting the offer. Decision making is effectively jointly in the hands of the board of directors and the shareholders; the board first determines whether the offer by the bidder shall proceed and the shareholders ultimately signify acceptance on the offer (whether by voting or by acceptance). It has been argued that this model allows the board to protect shareholders

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93 [2004] U.K.H.L. 28.

94 15 U.S.C. §§ 77a *et. seq.*

95 15 U.S.C. §§ 78a *et. seq.*

96 Williams Act, Pub L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2000).

of the target against opportunistic behavior on the part of the acquirer.[97] In particular, deal protections allow the board to enhance their bargaining position and seek a better deal for the shareholders.

While theoretically an unwelcome bidder may approach the shareholders directly through a tender offer (and bypassing the board), and at the same time launch a proxy solicitation to remove the incumbent management, it is much more disadvantageous for the bidder if the management does not support the particular offer (in the absence of bad faith). The directors of the target may utilize the poison pill or the shareholder rights plan, which dilutes the hostile bidder's stake if the bidder acquires more than a specified percentage of the target stock. The presence of the staggered board makes it impossible to remove the majority of the board unless it extends over at least two annual election cycles.[98]

Consistent with its approach towards allowing target management to have a significant say in who should be the ultimate acquirer or merger partner, Delaware law allows the use of termination fees and other lockups entered into by the target in more liberal circumstances than their U.K. counter-parts. The starting point under Delaware law is that decisions of the board are subject to the business judgment rule, that is, the directors are presumed to have exercised their decision with sound business judgment. Under the business judgment rule, the court will presume director independence, disinterestedness on the part of the directors, good faith and due care. The burden is on

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[97] *E.g.* Davies and Hopt, *supra* note 17, 168-171.

[98] Lucian A. Bebchuk, John C. Coates IV & Guhan Subranmanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, 54 STAN L REV. 887, 916 (2002).

the plaintiff to overturn these presumptions by showing breach of duties of loyalty and care. The court will not review the substantive merits of the decisions made by directors. However, in the context of deal protections, the courts have developed the following levels of scrutiny described below.

1. *Defensive measure scrutiny*

Defensive measures which do not amount to change of control of target are subject to *Unocal*. Actions are regarded as defensive if they impact corporate control, as distinguished from standard corporate actions taken in connection with the ordinary course of business. In *Omnicare, Inc. v. NCS Healthcare, Inc* ("*Omnicare*"), the Delaware Supreme Court made it clear that deal protections were regarded as defensive measures.[99]

In *Unocal*, in evaluating actions of the target board in response to the offer, the court held that the directors must demonstrate that: (a) the directors reasonably perceive a threat to the corporation and (b) their defensive measures are reasonable in relation to the threat posted by the hostile offer. Once the burden of proving (a) and (b) is satisfied, the actions of the directors qualify for the safe harbor of the business judgment rule. The burden then shifts back to the plaintiffs to show that directors' decisions should otherwise be impugned on the ground of breach of duty, such as conflict of interest or the fact that

[99] 818 A.2d 914 (Del. 2003). Another case which regarded deal protections as defensive is McMillan v. Intercargo Corp. 768 A.2d 492, 506 n. 62 (Del. Ch. 2000). *See also* Mark Lebovitch & Peter B. Morrison, *Calling a Duck a Duck: Determining the Validity of Deal Protection Provisions in Merger or Equals Transactions* 2001 COLUM. BUS. L. REV. 1 (2001).

the directors were motivated by bad faith.[100] If the directors fail to establish the initial burden set out under the two limbs of *Unocal*, the defensive measure may still be upheld on the ground that the measure is intrinsically fair, but the burden of demonstrating the intrinsic fairness is on the directors.[101]

Under the *Unocal* approach, the directors have considerable leeway on determining the size and type of the deal protections. The reasons are as follows.

First, to satisfy limb (a), the threat by a rival bidder does not need to be structurally coercive (such as unequal treatment of all shareholders) but it is sufficient if there is substantive coercion (risk that shareholders mistakenly accept an under-priced offer because they disbelieve management's presentations of intrinsic value). For instance, in *Paramount Communications v. Time, Inc.* ("*Paramount*"),[102] under the initial stock merger agreement between Time and Warner, Warner was to be merged into a wholly-owned subsidiary of Time, with Warner being the surviving corporation. The common stock of Warner would be converted into the common stock of Time. As a "safety device", there was a share exchange agreement, pursuant to which Time would receive 9.4% of Warner's outstanding stock and Warner would receive 11.1% of Time's outstanding stock and either party could trigger the exchange. The transaction required the approval of Time stockholders under the NYSE rules and the approval of the Warner stockholders under the DGCL. Prior to the Time shareholder vote, Paramount launched a $175 all cash, all shares tender offer for Time. In response, as a defensive measure, Time

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100 *See Unocal*, 493 A 2d 946, at 958 (Del. 1985).

101 Shamrock Holdings v. Polaroid (1989) 559 A 2d 257.

102 Paramount Communications Inc. v. Time, Inc. A.2d 1140 (Del. 1989)

and Warner restructured the initial merger agreement into a tender offer for 51% of Warner's outstanding stock. The tender offer had a cash component of $70 per share and the remaining 49% would be purchased for a mix of cash and securities worth $70 per share. Paramount increased its offer to $200 per share. Time's board rejected the Paramount offer as inadequate and argued that the merger with Warner offered a greater long-term value to Time shareholders, and that Paramount's offer was a threat to shareholder value and corporate entity. The share exchange agreement was ultimately triggered. The Supreme Court of Delaware found that such an offer, even though was structurally non-coercive, could justify a defensive response. Paramount's offer was found to present a threat, in that Time's shareholders may tender to Paramount in ignorance or mistaken belief of the benefits presented by a merger with Warner. Also, Paramount's offer was conditional, and hence uncertain, and was arguably timed to confuse and disturb Time's shareholder vote on the merger with Warner.

In addition, the directors' proof of satisfaction of limb (a) in *Unocal* would be materially enhanced if the defensive measures (including deal protections) are approved by a "board comprised of a majority of outside independent directors".[103] In a subsequent case, outside independent directors are defined as directors who are neither employees nor management and the decisions are made based on corporate merits rather than "extraneous consideration or influences".[104]

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[103] *See Unocal*, 493 A 2d 946, at 955.
[104] Unitrin, Inc. v. American General Corp. 651 A.2d 1361, 1375 (Del. 1995).

Second, to satisfy limb (b), the court is placed in a regulatory role in deciding whether a particular defense tactic was reasonable in relation to the threat posted by the offer once a threat is demonstrated. However, it is not difficult for directors to satisfy the court that their deal protection measures constitute measures that are proportional to the threat. In *Unitrin, Inc. v. American General Corp.*,[105] the Delaware Supreme Court held that defensive measures were upheld so long as they were neither coercive nor preclusive and were within the "range of reasonable responses".[106] A response is coercive if it is aimed at "'cramming' down on its shareholders a management-sponsored alternative" and a response is preclusive if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise.[107]

The "range of reasonable responses" test formulated in *Unitrin* shows that the enhanced scrutiny is actually much closer to the business judgment rule.[108] In the line of cases post-*Unocal*, directors are given considerable autonomy to enter into deal protections. In *Paramount*, the notion of shareholder primacy in takeover situations was not accepted by the Supreme Court of Delaware.[109] The defensive actions of the Time

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[105] *Unitrin*.

[106] *Unitrin*, 651 A.2d at 1367.

[107] *Unitrin*, 651 A.2d at 1387.

[108] It has been argued that the effect of the rule is that there is very limited enhancement to the business judgment rule; see WILLIAM T. ALLEN, REINIER R. KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS (2nd ed, 2007), 536.

[109] The Delaware Supreme Court rejected the argument made by Paramount that Time's response was unreasonable in precluding its shareholders from accepting the tender offer, holding that it was a "fundamental misunderstanding of where the power of corporate governance lies. Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives", See *Paramount* 571 A 2d 1140, 1154.

board survived judicial scrutiny, notwithstanding the substantially more superior bid from Paramount.

In *Omnicare*, the Delaware court held that the deal protections in question were coercive and preclusive. In that case, the controlling shareholders (holding over 65% of the shares) of NCS agreed to vote in favor of the merger with Genesis and the board agreed to submit the merger to the shareholders, even if the board believed, at the time of the vote, the merger was not in the best interests of the shareholders.[110] There was also a no-shop provision. A competing bid at a substantially higher bid price was made by Omnicare after the initial transaction was announced and the shareholders were not able to vote down the original deal with Genesis. The Delaware Supreme Court held, by a majority, that the deal protections were coercive and preclusive because they rendered the merger a *fait accompli*. The decision is unusual because the controlling shareholders had entered into the voting agreement and these shareholders (unlike the board) ordinarily did not owe any fiduciary duties to their fellow shareholders. The majority emphasized that deal protections continue to be evaluated under the *Unocal* standard of review, even in a stock for stock merger which would not trigger *Revlon* duties. The dissenting judgments stressed that the courts should not second guess the judgment of the board that has acted with due care or disregard the contractual intention of the majority shareholders. It is unclear whether and how *Omnicare* will affect termination fees and lockups. The better view, it is submitted, is that it is confined to force the vote clause (that is, the board cannot contract to give up its right to withdraw its recommendation or to withdraw the deal from shareholder vote) where the majority of the shares are subject to voting

[110] A force the vote provision was permitted under § 251(c) of the DGCL.

undertakings and does not stand for the more general proposition that all deal protections must be subject to a fiduciary-out.

2. *Auction rules*

If defensive measure is adopted in any one of the following circumstances: (a) the target puts itself up for sale; (b) the break up of the target is inevitable;[111] or (c) there is a change of control, *Revlon* rules will apply. *Revlon* does not apply if there is no change of control, such as a stock for stock merger that does not involve shift of control to one stockholder or affiliated group of stockholders.[112] Once *Revlon* duties apply, the directors are required to get the highest value for the stockholders in the circumstances[113] and maximize short-term value and the premise is that the transaction should be left unprotected so as not to preclude a higher-value bidder.

If an auction is conducted, the case law demonstrates the court will allow significant board discretion in the manner in which the auction is conducted. [114] If two or more bidders are treated on unequal terms, the target board has to demonstrate that their actions can reasonably be said to have fostered the bidding contest or procured the highest available offer, even if such actions have foreclosed other bids.[115] Accordingly, to

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[111] Mills Acquisition Co. v. MacMillan, Inc., Del. Supr., 559 A.2d 1261 (1989), 1288.

[112] A stock for stock merger can involve a change of control, such as that occurred in Paramount Communications v. QVC Network, Inc. 637 A.2d 34 (Del. 1993). Cash mergers normally trigger *Revlon* duties unless there is already a majority shareholder in the target. *See* ALLEN, SUBRAMANIAN & KRAAKMAN, *supra* note 108, at 578.

[113] *See MacMillan* where the court enjoined the lockup agreement in a case where *Revlon* applied.

[114] *MacMillan*, 559 A.2d at 1286-1287.

[115] *Id. See also* Paramount v. QVC 637 A.2d at 45 (the Court stating that the key features of the enhanced scrutiny test are (a) judicial determination regarding the adequacy of the decision-making process

justify granting a deal protection which is an auction-ending provision, it must confer a "substantial benefit upon the stockholders in order to withstand the exacting scrutiny by the courts".[116] Deal protections which are granted to a preferred bidder by a disinterested board of target which is adequately informed are more likely to be upheld.[117]

The cases post-*Revlon* tended to focus on situations where there were competing bids. What if there is no bidding contest? One view is that a form of market test is necessary before *Revlon* duties can be said to be satisfied, which may take the form of holding an auction prior to the agreement.[118] For example, in *Re Toys "R" Us, Inc., Shareholders' Litigation*, the fact that there was a lengthy and detailed market check by the board prior to the grant of the termination fee amounting to 3.75% of the equity value was regarded as significant in coming to the conclusion that it should be upheld.[119] In *Ryan v. Lyondell Chemical Company and others*,[120] the court refused to strike out the claim against the directors of a target founded on breach of loyalty on the ground that the target directors did nothing to check whether the bidder's price was the best that could

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employed by the directors, and (b) a judicial examination of the reasonableness of the directors' action in light of circumstances then existing. The court would not substitute the business judgment for that of the directors but would determine if the directors' decision was, on balance within a range of reasonableness).

[116] *MacMillan*, 559 A.2d at 1285.

[117] *E.g.* In re RJR Nabisco, Inc. Shareholders Litig., 556 A.2d 1070 (Del.Ch. 1989) (the President and CEO leading the buyout group did not select the board committee and members of the board committee had no financial interest in the bidder whose bid was endorsed by the board; even though the board eventually rejected a higher bid, the decision was protected under the business judgment rule). *C.f. MacMillan*, 559 A.2d. at 1267 (in enjoining the extensive lockups granted in favor of the preferred bidder, the Delaware Supreme Court raised the questions on the independence of the special committee that was picked by Evans, who was the Chairman and Chief Executive Officer of the target company, and of the committee's financial adviser, which had worked with the management on a proposed management-led recapitalization even before the committee came into existence. Before the special committee was formed, the directors had considered various recapitalization proposals which would involve the management team controlling the majority of the company).

[118] A recent innovation is the use of the go-shop clause, where the target is expressly permitted to shop for alternative bids for a limited period of time post-signing but prior to completion. *Supra*, n 22 and accompanying text.

[119] 877 A.2d 975 (Del. Ch. 2005).

[120] 2008 Del. Ch. LEXIS 105.

reasonably be obtained in the circumstances in a *Revlon* context. Accordingly, it is likely a market check conducted prior to granting deal protections devices will continue to be significant in the assessment of the validity of such devices.[121]

3. *Other standards and further developments*

The outline above on the standards of judicial review for M&A transactions is subject further to the following caveats. First, if the majority of the directors of the target stand on both sides of the transaction, the applicable standard of review is that of entire fairness under *Weinberger v. UOP, Inc*.[122] Under the entire fairness analysis, the burden is on the board to show the transaction is entirely fair, in terms of procedure and price. A properly functioning special committee of independent directors is required to shift the burden to the person alleging unfairness.[123] This situation is likely to be very rare it is unlikely for the directors of the target to stand on both sides of the transaction except in a parent-subsidiary merger. In such a case, deal protections will not arise since there is no sense in granting such protections by a subsidiary to its parent.

Second, if the actions of the directors that are adopted are found to be primarily for the purpose of impeding the exercise of stockholder voting power, the directors would

[121] For commentary on the *Revlon/ Unocal* divide, see Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521 (2002) at 554 (drawing an analogy with the whale swallowing the minnow, where in such a case, the acquirer may be indifferent between paying in cash or securities but the creates the perverse incentive for the target board to ask for stock acquisition to avoid *Revlon*).

[122] Weinberger v. UOP, Inc. 457 A.2d. 701 (Del. 1983).

[123] Kahn v. Lynch Communications Systems, Inc. 638 A.2d 1110 (Del. 1994).

be subject to the principles set out in *Blasius Industries, Inc. v. Atlas Corp*.[124] In *Blasius*, it was held that a compelling justification must be found for its actions. While conceivably it could be argued that an exceptionally large termination fee or a lockup on unusually generous terms to the acquirer would effectively coerce the stockholders to vote for the merger, *Blasius* analysis has never been extended to termination fees or lockups.[125]

Third, one particular development that should be highlighted is that increasingly, loan covenants entered into by companies contain change in control provisions which require the companies to pay back outstanding loans if there is a change of control or ownership.[126] These are covenants which are granted by the companies to third parties but they have anti-takeover effects. It appears that the directors' ability to enter into these covenants will be subject to the business judgment rule.[127] With the tightening of credit post-financial crisis of 2008, acquirers looking to acquire target companies with change of control provisions have to ensure that not only do they have sufficient funds to pay for the acquisitions, they must have standby lines of credit if the target companies are forced to repay the debt. Standby lines of credit require a commitment fee payable to the banks, which will increase costs of doing takeovers.

V. REASONS FOR THE DIFFERENCES

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[124] Blasius Industries, Inc. v. Atlas Corp 564 A.2d 651 (Del. Ch. 1988).

[125] An argument could be made that if the lockup confers voting power on the acquirer, as was the case in JPMorgan/Bear Stearns merger, *Blasius* could be implicated. See Kahan & Rock, *supra* note 31.

[126] Ronald Grover, *A Hot Weapon in Proxy Battles*, BUS. WEEK, Apr. 20, 2009.

[127] See discussion in Talley & Arlen, *supra* note 33.

A. *Historical impact of institutional share ownership and shareholder activism*

U.K. and U.S. regard deal protections as defensive measures. However they differ markedly their respective approaches towards these defensive measures. The U.K. approach is shareholder-centric which regards termination fees and their functional equivalents as potentially adverse effects to target shareholders and safeguards are required. In contrast, U.S. law, in contrast, gives considerable leeway to the management of the company to put in deal protection devices to ensure that the preferred bid is not unraveled by a competing bid. The differences in approaches arise from the different historical impact that institutional share ownership has on takeover regulation in the two jurisdictions.

1. *United Kingdom*

This Part analyses the impact on institutional shareholder ownership on U.K. takeover regulation. The thesis is that institutional share ownership has significantly influenced the development of a self-regulatory takeover regime in the U.K., which ultimately led to a system which is based on shareholder choice.

Historically, institutional share ownership has long been higher in the U.K. than the U.S. [128] In the U.S., institutional investors (defined as pension funds, insurance companies, banks and foundations) held 23% of all corporate equities in 1950, which

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[128] For a much fuller account of the history in the shareholding patterns of U.K. companies, see BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED (Oxford Univ. Press, 2008) [hereinafter CHEFFINS], at chs 5 – 10.

increased to 53.3% in 1990[129] and 66.3% in 2006. In the U.K., in the beginning of the 19th century, shareholdings were mainly held by the founders and their families. As the capital needs of the companies grew, shares were offered for sale. Following the Second World War, blockholders began to exit and institutions began to buy. The holdings of U.K. institutions (pension funds, mutual funds, insurers, banks and other financial institutions) rose from 30.3% in 1963 to 60.5% in 1991.[130] By the end of 2006, these holdings declined to 42.8% due to the fact that that U.K. pension funds and insurers began to sell down the equity holdings of U.K. companies and purchase international equities and bonds, and the foreign investors stepped up as the key purchasers.[131]

Until the 1990s, U.K. institutional shareholders traditionally did not engage in company-specific activist activities.[132] However, they were not entirely passive and through trade associations, they have significantly influenced the promulgation

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[129] The statistics for 1950 and 1990 are found in Carolyn K. Brancato & Patrick A. Gaughan, INSTITUTIONAL INVESTORS AND CAPITAL MARKETS: 1991 UPDATE (Sep 1991), cited in Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective,* in INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE (Theodor Baums *et al.* ed), 201, 203. For statistics for 2008 are found in Press release, The Conference Board, *U.S. Institutional Investors Boost Ownership of U.S. Corporations to New Heights* (Sep. 2, 2008), *available at* http://www.conference-board.org/utilities/pressdetail.cfm?press_id=3466 (last visited May 26, 2009).

[130] OFFICE FOR NATIONAL STATISTICS, SHARE OWNERSHIP: A REPORT OF OWNERSHIP ON UK SHARES AS AT 31 DECEMBER 2006 (Her Majesty's Stationery Office, 2007).

[131] Tony Cassell & Lina Saigol, *International investors in the UK are buying up the keys to the Kingdom,* FIN. TIMES, Jun. 22, 2005 (explaining that this is the result of pension funds and insurers buying international equities and bonds to diversify). See CHEFFINS, *infra* note 128, at 387 (explaining that the rise of foreign shareholding was the result of a combination of regulation and market forces. During the 2000-03 stock market downturn, insurers began to sell down the equities in order to shore up their 'free asset ratios'. The 2004 regulatory changes by the Financial Services Authority required insurers to adopt the more pessimistic of two measures of assets versus liabilities, the traditional method where the investment assets were valued based on market but liabilities were not adjusted accordingly, or an appropriate designed to reflect directly the impact on market fluctuations on liabilities; the effect of such changes was to encourage insurers to invest in bonds rather than equities. A change in the taxation of dividends as well as the adoption of liability driven investing led to pension funds decreasing their investment in shares).

[132] *See* CHEFFINS, *supra* note 128, at 375-381

development of the Takeover Code, which forms the bedrock of the takeover regime in U.K.

The catalyst for the Takeover Code was the alarm raised over hostile takeovers in the 1950s.[133] In 1959, at the initiation of the governor of the Bank of England, the Issuing Houses Association and the Accepting Houses Committee (the merchant banks), the Association of Investment Trusts, the British Insurance Association, the Committee of London Clearing Bankers and the London Stock Exchange came up with the 1959 Notes of Amalgamations of British Business. The 1959 Notes stipulated that a takeover offer should be for all of the shares of the company (thus ensuring equality of treatment to all shareholders). The revision to the Notes in 1963 addressed more broadly other aspects of the issue relating to the equality of treatment of shareholders. However, between the period 1961 to 1968, it was clear that the revised Notes were flouted in many instances.[134]

In 1968, the Bank of England, the London Stock Exchange, leading issuing houses and major institutional investors sponsored the creation of the Takeover Panel, which had the responsibility for administering and enforcing the new body of rules referred to as the City Code on Takeovers and Mergers. The 1968 Takeover Code reiterated the requirement of similar treatment of all the shareholders of the same class but introduced the most important principle that survives to the present day, that is, the board of a target company should not frustrate a bona fide offer without first seeking the

[133] *See* Johnston, *supra* note 63.

[134] Dan D. Prentice, *Takeover Bids – The City Code on Takeovers and Mergers* 18 MCGILL L.J. 385 (1972).

approval of the shareholders and introduced the rule precluding the board of a target company from issuing shares, disposing assets or entering into major contracts without prior shareholder approval.[135] The principle of no-frustration remained largely intact in the current version of the Takeover Code.

In the late 1990s, after termination fees first began to make their appearance in the U.K. market in merger transactions involving U.S. and U.K. companies,[136] the Panel issued a statement reiterating the importance that the interests of the target shareholders should not be adversely affected by inducement fee arrangements and there were concerns that a bona fide bid may be frustrated bid by reason of these arrangements.[137] The Panel regarded the amount of inducement fee that could be agreed by the target would normally mean no more than 1% of the offer value.

The situation that emerges is a regulatory framework which tightly controls post-bid conduct by target management. However, even though pre-bid defenses are not subject to the Takeover Code, what is equally noteworthy is that U.K. companies hardly engage pre-bid defensive measures. In this respect, the situation is again explicable by the influence of the institutional shareholders. While U.K. institutional shareholders have been passive in relation to the companies in which they have holdings, the trade associations representing U.K. institutional investors nevertheless had a major influence

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[135] THE PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS 1968, Principle 3, Rule 34, cited in CHEFFINS, *supra* n 128 at 369.

[136] George Graham, *Outer Fortifications are Starting to Fall: Break fees; The U.K. has managed to resist some practices imported from the U.S. but it must learn to live with others*, FIN. TIMES (U.K.) Sep. 22, 1999 at 6 (giving examples of transactions carrying break fees appearing in the U.K. market including the merger between British Telecom and M.C.I. in 1997).

[137] THE PANEL ON TAKEOVERS AND MERGERS, STATEMENT 10 OF 1999, INDUCEMENT FEES, *available at* http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/12/1999-10.pdf (last visited Jun. 1, 2009).

on takeover regulation, often with the effect of seriously limiting the steps which target board can take as pre-bid defensive measures. The following examples illustrate.

Institutional shareholders have always opposed the issuance of non-voting shares or weighted voting shares.[138] Although there is no legislation or stock exchange rule prohibiting or restricting the issuance of non or weighted voting shares, U.K. publicly traded companies hardly issue classes of equity shares that carry different voting rights from the ordinary shares (apart from non-voting preference shares).[139]

In addition, as explained in Part IV(A) above, if the company wishes to issue shares on a non-pro rata basis, the Companies Act requires directors to have received authorization for not only the issuance of shares but also the disapplication of the pre-emption rights. Institutional shareholders have insisted that the rules on disapplication of such rights should be more restrictive that the Companies Act allows. While the legislation allows for the disapplication of the pre-emption rights for up to five years so long as the requisite shareholder approval is obtained,[140] the non-binding Statement of Principles, which is drawn up by the Pre-emption Group that has institutional shareholder

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[138] WEINBERG AND BLANK ON TAKEOVERS AND MERGERS (William Underhill ed., 5th ed. 1989 & Supp. 2006), § 4077 (reporting that institutional shareholders having a strong dislike for non-voting shares and that there are no instances in recent years of a company seeking a listing for any new class of non-voting equity capital).

[139] M.J. Brennan and J. Franks *Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK,* 45 J. FIN. ECON. (1997) 391 (stating that investing institutions and the London Stock Exchange have discouraged the issuance of non-voting shares and other devices for discriminating against different shareholders). See also Eilis Ferran, COMPANY LAW AND CORPORATE FINANCE (Oxford Univ. Press, 1999), at 246 (giving examples of some of companies that had the non-voting shares cancelling them in 1990s).

[140] PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW (8th ed., 2008) [hereinafter GOWER AND DAVIES], at 840.

support,[141] provides that institutional shareholders will normally support routine disapplications only when the company in question undertakes to limit any non-rights issue to 5% of the issued share capital of the company in any one year, and restrict the discount to 5% of the market price. These pre-emption guidelines are put in place to protect institutional shareholders against dilution but they limited significantly the ability of the board to undertake pre-bid defensive measures that involve or potentially involve the issuance of shares.

In the area for corporate control, the resulting system in the U.K. is one of a shareholder-centric model, in which trade associations representing institutional shareholders had significant influence in developing. Post-bid, termination fees (and their functional equivalents) are viewed as potentially having an adverse impact on shareholder choice. Pre-bid, institutional shareholders have ensured that target management does not have the ability to erect strong takeover defenses in anticipation of defending against other bids.

2. *United States*

In 1932, Berle and Means wrote their classic study of shareholding patterns of large U.S. corporations;[142] they analyzed the paradigm U.S. corporation as being one that

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141 PRE-EMPTION GROUP, DISAPPLYING PRE-EMPTION RIGHTS: A STATEMENT OF PRINCIPLES, July 2008, available on http://www.pre-emptiongroup.org.uk/documents/pdf/Statement%20of%20Principles%20July%202008.pdf . These Guidelines were adopted initially in 1987. The Pre-emption Group is supported by the Association of British Insurers, the National Association of Pension Funds and the Investment Management Association.

142 ADOLF A. BERLE AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (New Brunswick 1991) (1932).

had strong managers and widely dispersed shareholders and professional managers control large corporations. Scholars have given various explanations on the shareholding pattern. In particular, Mark Roe has explained that over-regulation in the U.S. federal regulation during and before the 1930s has led to the impediment in the scale, scope and power of financial institutions in the U.S., thereby deterring them from taking a close interest in the activities of corporate executives and undermining their ability to coordinate with one another.[143] Absent such constraints, a very different result could occur, similar to Germany and Japan, where financial institutions play an active monitoring role.

However, the shareholding patterns in the U.S. have not remained static. Since the 1980s, there has been a concentration in publicly traded companies in the hands of institutional investors. U.S. pension funds have steadily increased to be become the largest block of institutional shareholders, with 32.6% and 38.3% of total assets under management in 1980 and 2006 respectively.[144] Within the pension fund group, state and local funds held 11% of all institutional assets or 28.7% of all total pension fund assets in 2006.[145]

At the same time, institutional investors have begun to play a more active role in corporate governance. Between 1987 and 1994, it was reported that public pension funds

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[143] MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE *(*1994), ch.1

[144] CAROLYN K. BRANCATO AND STEPHAN RABIMOV, THE 2008 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN INSTITUTIONAL INVESTOR ASSETS AND EQUITY OWNERSHIP OF US CORPORATIONS (2009), 4.

[145] *Id*.

sponsored 463 proxy proposals seeking changes in the corporate governance.[146] During this period, institutional shareholders submitted proposals related to anti-takeover devices such as the repealing of poison pills and submitting poison pills to shareholder votes, and proposals for structural changes, including proposals relating to the voting of board members, declassifying boards of companies with classified boards and having independent boards and board committees. In 1992, the SEC passed new proxy rules[147] which made it easier for shareholders to communicate with one another and coordinate their actions in proxy solicitations.[148]

Most of these shareholder resolutions controlling the boards' use of the pills were either not successful or were only precatory in nature. [149] However the resolutions have a more positive impact in relation to board composition. Shareholders resolutions on declassifying boards have garnered more shareholder votes and by the 1990s, companies which did not have classified boards generally would not succeed in gathering enough votes to amend their charters to adopt classified boards.[150] Throughout the 1990s and the early years of 2000s prior to the introduction of SOX, the trend showed that the number of U.S. companies whose boards comprised a majority of independent directors

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[146] Stuart L. Gillian and Laura T. Stark, *Corporate Governance Proposals and Shareholder Activism: the Role of Institutional Investors* 57 J. Fin. Econ. 275 (2000) citing data from Investor Responsibility Research Center, CORPORATE GOVERNANCE BULLETIN, 1991-1994.

[147] Regulation of Communication Among Shareholders, Securities Exchange Act of 1934, Release no. 31,326, 57 Fed. Reg. 48, 276 (Oct. 16, 1992).

[148] After these rules were promulgated, it was reported that institutional shareholders rely less on proxy proposals (which is more expensive) and more on direct negotiation with management: see Gillian and Stark, *supra* note 146, at 279.

[149] Marcel Kahan & Edward B Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law* 69 U. CHI. L. REV. 871 (2002), 885-886**.**

[150] Kahan & Rock, *id.* at 885-886.

increased.[151] In 2002, the amendments to the NYSE and Nasdaq listing rules (arising from SOX) required the boards of listed corporations to comprise a majority of independent directors.[152] A study of 1,500 S&P companies showed that companies whose boards were at least two-thirds independent was 85% as at 2008.[153]

Why is there a movement towards more independent boards?[154] There is evidence that boards with independent directors are more likely to dismiss an underperforming CEO and less willing to endorse an overpriced bid (from the acquirer's perspective).[155] In the takeover context, outside directors of target boards are less likely to agree with the CEO's assessment on whether to do the merger or acquisition with the particular acquirer without actively scrutinizing the merits of the deal, including questioning the existence of any management self-interest. They can stop a misguided merger or acquisition even before the termination fee or lockup signed. In other words, increasing the number of outside directors can mitigate the potential agency problems.

Thus the situation in the U.S. has evolved in the form of market participants pushing for the boards of corporations to become more independent in order to counteract managerial self-interest. In order to incentivize outside directors to do their job properly,

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[151] James S. Linck, Jeffry M. Netter & Tina Yang, *The Determinants of Board Structure* 87 J. FIN. ECON. 308 (2008) (showing, in Panel B, the trend of insider-dominated boards which has fallen since 1990, with the trend most pronounced for small and medium firms.)

[152] "Independence" of a director is defined in detail in NYSE, Inc., LISTED COMPANY MANUAL, § 303A (2002) and in Nasdaq, Inc. LISTED RULES, Rule 5605.

[153] Riskmetrics Group, *Board Practices: Trends in Board Structure at S&P 1,500 Companies*, December 17, 2008.

[154] Kahan and Rock, *supra* note 149 (calling the market participants' embrace of more independent boards as "adaptive devices"), at 872.

[155] Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence* 39 UCLA L. REV. 895 (1992).

since the 1980s, outside directors of U.S. publicly traded companies are increasingly being paid stock or stock options as compensation for their services.[156] The aim is to directly align the interests of directors and shareholders, incentivize the outside directors to maximize takeover returns.[157] Although the Enron and Worldcom saga show that equity-based compensation is not, in itself, the perfect answer to self-interested behavior of executives, it is at least a partial solution to the agency problem. The number of U.S. companies keeping the roles of the chairman of the board separate from the CEO has increased significantly.[158] Not allowing an individual to hold the position of chairman and CEO is regarded as improving governance as it avoids concentrating too much power in the hands of the individual.

The development towards enhancing board independence is also consistent with Delaware case law. Special emphasis has always been given to the role of disinterested outside directors in the takeover process under Delaware law. In 1981, the Supreme Court of Delaware held that where it is alleged that the acquirer stands on both sides of the transaction, the burden of proof shifts to the party alleging unfairness if the decision is made by a committee of independent directors.[159] In wave of takeovers in the 1980s, corporations form special committees of outside directors to assess the merits of the

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156 David Yermack, *Remuneration, Retention and Reputation Incentives for Outside Directors*, 59 J. FIN. 2281 (2004) (estimating the personal financial gains of more than 700 directors appointed by Fortune 500 firms between 1994 and 1996).

157 *Infra* note 203 and accompanying text (discussing the possible negative impact of equity compensation).

158 Riskmetrics Group, *supra* note 153 (pointing out that as at June 2008, 46% of the S&P 1,500 companies had separate individuals serving as chairman and CEO, an increase of 21 percentage points since 2001, and almost half of the separate board chairs are regarded as independent).

159 *Weinberger*, supra note 122

proposed transactions.[160] For defensive measures (which would include taking deal protection measures with favored bidders to lockup the transaction), the approval of such measures by outside independent and disinterested directors substantially enhance the directors' proof that the directors had reasonable grounds for believing that the bidders acted in a manner that posed a danger to corporate policy and effectiveness.[161]

In contrast, in the U.K., the Takeover Code strongly emphasizes on the rights of the shareholders to determine the merits of the offer.[162] The board of the target has to give its opinion on the merits of the offer and if a director faces a conflict of interest, he is required to abstain from joining the other directors in giving the opinion.[163] The Takeover Code does not otherwise deal with the role of outside directors, even though the role of independent directors in corporate governance practice has been highlighted in the corporate law landscape since 1992.[164]

B. *Incentives for Bidder*

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160 *See* William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?* 45 BUS. LAW. 2055 (1989) (assessing the efficacy of the special committees of boards in the sale process).

161 *Supra*, n 104 and accompanying text.

162 TAKEOVER CODE, General Principle 2.

163 TAKEOVER CODE, Rule 25.1, Note 3.

164 The corporate governance codes originated with REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (Dec 1992) (being a report from the Cadbury Committee) [hereinafter known as the CADBURY COMMITTEE REPORT], and it was subsequently followed by DIRECTORS' REMUNERATION, REPORT OF A STUDY GROUP (Gee, 1995) (being a report from the Greenbury Committee) and FINAL REPORT OF THE COMMITTEE ON CORPORATE GOVERNANCE (Gee, 1997) (being a report from the Hampel Committee). The current COMBINED CODE ON CORPORATE GOVERNANCE [hereinafter COMBINED CODE] requires non-executives are to make up at least half of the board. While compliance with the COMBINED CODE is voluntary, the U.K. DISCLOSURE RULES AND TRANSPARENCY RULES (Rule 7.2) require companies to disclose how they have complied with the Combined Code or if they have not done so to explain the reasons for the departure.

In addition to the different underlying principles in takeover regulation explained in Part V(A) above, the bidder which is bidding for a U.S. target has greater incentives to secure a larger termination fee than if it is bidding for a U.K. target. Out of pocket expenses of the bidder, in the form of legal and other due diligence costs and financing fees, in a typical U.K. transaction are unlikely to exceed 1%, save in unusual circumstances.[165] Even assuming that these out of pocket expenses in both jurisdictions are similar, it could be argued that a bidder making a bid for a publicly listed target in U.S. may incur greater fees than if it had made a bid for a comparable U.K. target for the following reasons.

First, relation to the manner in which disputes are resolved, in the U.S., the resort to litigation as a means to adjudicate disputes is frequently used. [166] Even though the deal between the preferred bidder and target is initially friendly, it may be subject to challenge by the target shareholders (on behalf of the target) the ground that the deal protection is too onerous or otherwise violates fiduciary duties. The bidder will be a party to the litigation because it is enjoined from completing the transaction. Once challenges to the transactions are made by way of litigation, costs in terms of significant management time and legal fees need to be expended.

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[165] It has been suggested that based on the estimated legal and due diligence costs (between £0.5 million to £2 million and loan financing of 0.5% to 1%, a fee above 1% of the deal value could hardly be justified by actual costs incurred by the bidder, unless the deal is relatively small or is complex. See Alan Gregory, *Discussion of Termination Fees in Mergers and Acquisitions: Protecting Investors or Managers*, 34 J. BUS. FIN. & ACCT. 567 (2007).

[166] A study of U.S. transactions on the ThomsonOne database of transactions between 1990 to 2005 show that litigation occurs in 33.9% of the all the hostile transactions. See Armour & Skeel, *supra* note **Error! Bookmark not defined.** at 1748 (Table 2 showing the number of hostile transactions that are litigated.)

In contrast, the market participants in takeover process in the U.K. rely on the Takeover Panel to give rulings speedily. Lawyers may but need not be involved.[167] The courts are not as involved for a number of reasons. U.K. procedural rules do not encourage target shareholders from bringing of shareholder suits on behalf of the company against the directors in the courts. Under the proper plaintiff rule, the wrong is done to the company and the decision to bring a lawsuit is regarded as a management decision of the company, and only the board of the company may bring such a suit. A derivative action against the company may only in brought in exceptional circumstances. At common law, the shareholder needs to show "fraud in the minority", which requires *inter alia*, the showing that there is wrongdoer control.[168] Neither do the newly enacted derivative action rules under the Companies Act[169] encourage the bringing of lawsuits. If the derivative action is successful, the company (and not the shareholders) keeps the gains. However, if the defendant loses, he ends up paying the winner's costs. Further, contingency fees are disallowed. While conditional fee arrangements are permitted, the maximum upside for lawyers participating in such agreement is limited to 100% of their hourly charged –out rates.

Second, until recently, U.K. transactions are typically structured as takeover offers which are typically completed in short time periods, thereby reducing the risks faced by the bidders.[170] The Takeover Code specifies the time period for which a

[167] TAKEOVER CODE, Introduction, para. 7(c) provides that "Although not usual, parties may, if they so wish, be presented by legal advisers."

[168] Prudential Assurance Co. Ltd. V. Newman Industries Ltd. (No. 2) [1982] Ch. 204.

[169] Companies Act, Part 11 (ss 260-269).

[170] However, it should also be noted that there are signs that there is a trend for U.K. transactions to effect friendly transaction by way of a scheme of arrangement (rather than an offer), to take into account the more favorable rules for achieving 100% control. See THE TAKEOVER PANEL, ANNUAL REPORT 2007-

takeover offer must be open and when it has to be completed.[171] The objective of a tightly regulated timetable is to minimize uncertainty and disruption brought by a bid.[172] If a competitive situation arises, such as there being more than one bid for the target, revisions to offers must be made in published in accordance with an auction procedure determined by the Panel.[173] In contrast, again until recently, a U.S. M&A transaction effected by way of a merger takes much longer to complete.[174] If it is structured as a tender offer in the U.S., there is a minimum offer period of 20 business days[175] but it can be extended indefinitely. Until the recent amendment to the SEC rules in 2006,[176] tender offers were hardly used to effect friendly transactions because of the uncertainties in whether the "best price rule" applies to employee arrangements. A longer completion time has direct costs implications. If it is an equity offer and the bidder needs to incur underwriting fees, such fees will be dependent upon the length of time in respect of which the underwriting commitment lasts. An inflation of underwriting costs will result if

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08, *available at* http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/report2008.pdf (last visited Jun. 1, 09) (reporting that in the year ended Mar. 31, 02, 10% of the takeovers regulated by the Panel were effected by way of scheme of arrangement and in the year ended Mar. 31, 08, the figure rose to 41%. *See also* Practical Law Company, *Deal Analysis: Analysis of Schemes of Arrangement Used to Effect Takeovers*, data available as at May 31, 09, *available at* http://www.practicallaw.com/4-217-0003 (last visited Jun. 1, 09) (reporting that for deals with a value of £250 million, in 2007, 28 were structured were announced or subsequently structured as schemes of arrangement and 6 were offers; between January to November 2008, these figures were 14 and 8 respectively).

[171] TAKEOVER CODE, Rule 31.6 (the offer may not be open for acceptances beyond 60th day after the initial offer document is posted unless the offer is unconditional as to acceptances, and all conditions must be satisfied within 21 days. The offer document should normally be posted within 28 days of the announcement of the firm intention to make an offer under TAKEOVER CODE, Rule 30.1. Note, however, that Rule 31.6 will not apply to an offer which is structured as a scheme of arrangement. The rationale for not applying the same rules on timing to a scheme of arrangement was that the scheme of arrangement required court sanction and it may not be possible to align the court time-table with the offer timetable. See THE TAKEOVER PANEL, STATEMENT BY THE CODE COMMITTEE OF THE PANEL FOLLOWING EXTERNAL CONSULTATION PROCESS ON PCP 2007/01, RS 2007/1 (Nov. 29, 2007)

[172] WEINBERG AND BLANK, *supra* note 138, § 4-4039.

[173] TAKEOVER CODE, Rule 32.5.

[174] *See* Walters *et. al., supra* note 4 (survey shows that the average time to complete the U.S. deal is about 5 months).

[175] *Supra* note 40 and accompanying text.

[176] 17 C.F.R. Parts 200 and 240, Release No 34-54684 (Nov. 1, 2006).

the bid completion is delayed. A longer completion period means that the parties may have to do the planning and integration prior to completion, which will be wasted if the transaction is not completed.

The different processes of takeover regulation may provide a partial explanation of why a bidder in a U.S. transaction may be subject to higher bid costs (which will be wasted if the transaction is not completed) and hence have incentives to request for higher termination fee. However, the direct out of pocket costs are unlikely, in themselves, account for the substantially higher termination fees seen in U.S. transaction.[177] The bidder in U.S. transaction also wants to protect itself from other costs, including indirect costs, such as loss of management time in reviewing the bid to the exclusion of other possible M&A transactions. If the bidder is publicly listed, it may suffer reputation harm (especially if it has outlined the business reasons for acquiring the target and such acquisition has failed). The difficult is distinguishing termination fees and lockups that compensate the bidder for direct and indirect costs and those which deter other bidders due to self-interested management.

VI. TRENDS, IMPLICATIONS AND ANALYSIS

A. *Changing Shareholder Ownership Patterns*

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[177] Micah S. Officer, *Termination Fees in Mergers and Acquisitions* 69 J. FIN. ECON. 431 (2003). (drawing attention to the 'punitive' element of U.S. break fees). In one U.S. transaction, in U.S., a termination fee of 2% of the target's market capitalization was regarded as a reasonable estimate of the bid costs and other opportunity costs associated with the termination: s*ee* Brazen v. Bell Atlantic 695 A.2d 43 (1997).

1. *United States*

The analysis on the shareholding patterns in U.K. and U.S. raises the question as to whether the increasing concentration in institutional ownership in U.S. companies may result in the U.S. moving towards the U.K. model of takeover regulation that is based on shareholder choice. While U.K. has long had a level of institutional ownership that exceeds the U.S. levels, the U.S. levels of institutional ownership have increased rapidly since 1950. It has been thought that the U.K. experience with the rise of institutional ownership may be relevant to future changes and trends within U.S. corporate environment.[178] In principle, concentration of institutional shareholding should reduce the problem of free-riding effects of dispersed shareholding, and bring about shareholder pressure on management. The U.K. examples have shown that collectively, professional bodies representing the institutional investors may be influential in making takeover and corporate governance changes.

Commentators have argued that the rise in institutional shareholding and institutional activism can potentially be an effective constraint on agency costs in the corporation.[179] Since institutions hold larger blocks than individuals, they have the incentives to develop expertise in the making and monitoring of investments. While funds could simply sell their holdings in under-performing companies, the holdings are

[178] *E.g.* see John. C. Coffee, Jr. *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, Ch 11, European Takeovers Law and Practice (ed. by Klaus J. Hopt and Eddy Wymeersch) (1992).

[179] Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Voice* 39 U.C.L.A. L. REV. 811 (1991).

so large that the shares may not be sold without causing the prices to fall and suffering further losses. They also have greater access to information.

However, it is unlikely that the rising institutional share ownership in the U.S. equity markets will shift Delaware takeover regulation to a regime based on shareholder choice for the following reasons.

First, John Armour and David Skeel have argued that the U.K. shareholder centric is a product of a self-regulatory regime which is heavily influenced by trade associations representing institutional shareholders.[180] The Takeover Code was drafted with the involvement of institutional shareholders. Dispute resolutions are resolved by the Takeover Panel which is appointed by market participants. All these ensure that the system is one of a pro-shareholder approach which maximizes shareholder returns. In contrast, U.S. federal regulation, namely the securities regulation in the 1930s, has pre-empted the possibility of self-regulation as mandatory oversight was by Congress and the Securities and Exchange Commission. The most significant aspects of takeover regulation is Delaware judge-made law and there is a structural bias for judicial decisions to be pro-managerial.[181]

Second, more crucially, the evidence does not suggest that U.S. shareholders favor takeover regimes based on U.K.-style strict shareholder choice. Despite the rise in institutional share ownership since 1990s, investors have not constrained the board in

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180 Armour & Skeel, *supra* note **Error! Bookmark not defined.**.

181 *Id.*, at § III(C).

rejecting poison pills. In a study of charter provisions of over 300 IPOs between 1994 and 1997, more than half of the companies explicitly include a takeover provision and 60% of the companies established a staggered board or make it difficult for shareholders to replace the board between annual meetings.[182] Even though companies could theoretically "opt out" of Delaware's approach in their charter provisions by requiring all potentially frustrating actions by the board to require shareholder approval, companies have not done so. Even companies that are going public for the first time have not included such provisions.[183] All these give support to the views that U.S. shareholders may prefer to use other devices to constrain shareholder power, such as requiring more independent directors on the boards of the companies.

Third, the trend that emerges is that of institutional shareholders seeking more effective independent boards and this trend is likely to continue. For the activist hedge funds, it has been reported that they are pushing for structural or organizational changes, rather than traditional activist demands like selling divisions, buying back stock and issuing large dividends.[184] The SEC recently revisited the issue relating to director nomination, proposing amendments to the rules which make it easier for shareholders to nominate up to 25% of the company's board of directors.[185] It appears that the direction taken in U.S. is to continue to allow for target board autonomy, but decisions will be taken by more independent boards. Institutional shareholder monitoring efforts will be

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[182] Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs,* 17 J.L. ECON. & ORG. 83 (2001).

[183] See Kahan and Rock, *supra* note 149, at 894-895.

[184] Zachery Kouwe, *Among Activist Investors, a New Hesitancy*, NY TIMES, Mar 26, 2009, p F6.

[185] Press Release, SEC, *SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors,* May 20, 2009, *available at* http://www.sec.gov/news/press/2009/2009-116.htm.

indirect and effected through the boards of directors. This development is likely to occur even in the area of corporate control.

2. *United Kingdom*

In the U.K. the institutional shareholders are mostly fiduciary institutional investors, that is, fund managers and other institutions which control shares on behalf of others, normally pension fund trustees, pensioners and other savers.[186] Pension funds and insurance companies collectively held 9% in 1957, which increased to 33% in 1975 and 51% in 1991.[187] However, the composition of institutional shareholding in the U.K. has changed significantly. Since 2000, U.K. pension funds and insurance companies have reduced their holdings in equities. In 2006, their combined holdings were at 27% of the total equity and instead, the shareholdings of foreign holders have increased to 40% as at 2006.

Historically, U.K. institutional investors did not engage in company-specific shareholder activism. In the 1990s, there were instances in company-specific shareholder activism, [188] particularly in relation to issues on executive pay[189] though a review in 2001

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[186] COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: FINAL REPORT (London: DTI, 2001), para 6.20.

[187] *See* CHEFFINS, *supra* note 128, at 86-93.

[188] Brian Cheffins explained that the increase in shareholder activism was the result of, *inter alia*, reduction of the number of hostile offers which would serve as disciplinary measures to the managers and the 1993 introduction of the requirement in the London stock exchange rules that require quoted companies to report on compliance with the code on best practices recommended by the Cadbury Committee, which emphasized the importance of good corporate governance and made it easier for institutional shareholders to be proactive. See CHEFFINS, *supra* note 128 at 383-384.

demonstrated that the levels of engagement with management of investee companies were still low.[190] The increasing fragmentation among the institutional shareholders may make it more difficult for the major U.K. pension funds, insurers and fund managers to coordinate and mount a challenge to management decisions.

Nevertheless, in the wake of the recent 2008 financial crisis, questions have been raised as to the effectiveness of institutional shareholder monitoring on corporate managers, especially in areas of risk management for banks. Clearly the institutional shareholders' preferred method of effecting changes via behind the scenes consultations had not been a success.[191] In the first half of 2009, there is documented a much higher incidence of shareholders (including foreign institutional investors) voting on remuneration matters of U.K. companies.[192] In response to the financial crisis, the Institutional Shareholders' Committee[193] has issued a paper, outlining ways to increase engagement with management.[194] In a market downturn, it is clear that is more optimal to

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[189] The catalyst for open shareholder confrontations on executive pay was the introduction of the right of shareholders to vote annually on remuneration matters, albeit on an advisory basis: Companies Act, § 439; *see also* Companies Act 1985 (U.K.), § 241A.

[190] PAUL MYNERS, INSTITUTIONAL INVESTMENT IN THE U.K.: A REVIEW (2001) at 89-91.

[191] *See* Kate Burgess, *Investors up in Arms over Poor Governance*, FIN. TIMES (U.K.), Feb. 3, 2009, at 19.

[192] In May 2009, 59% of shareholders voted down Shell's remuneration report: *see* Kate Burgess, *Shell's executive pay plan voted down in shareholder rebellion,* FIN. TIMES, May 20, 2009, at 1 (noting that institutional investors from U.S., Europe and Canada were present at Shell's annual general meeting to speak out against the report). In April 2009, 90.4% of the shareholders voted down Royal Bank of Scotland's remuneration report.: see Andrew Bolger, Kate Burgess and Jane Croft, *Thumbs Down for RBS Pay Report; Reject RBS Pay Report*, FIN. TIMES (U.K.), Apr. 4, 2009, at 12 (noting that the 90.4% who voted down the remuneration report includes the governmental body that controls a 58% stake in Royal Bank of Scotland).

[193] The members of the Institutional Shareholders' Committee are the Association of British Insurers, The Association of Investment Companies, the Investment Management Association and National Association of Pension Funds.

[194] Institutional Shareholders' Committee, *Improving Institutional Investors' Role in Governance* (Jun. 5, 09), available at http://www.abi.org.uk/Document_Vault/ISC_Governance_Paper.pdf (last visited, Jun. 6, 09) (emphasizing the necessity of regular dialogue with management, chairs of key board

call the management into account by the exercise of voice rather than by exit via selling the shares of their under-performing portfolio companies.

In spite of the changes in the composition of shareholders of U.K. companies, it is unlikely that the Takeover Code's pro-shareholder orientation will change, given the current financial crisis. At the recent implementation of the EU Takeover Directive, the U.K. was not obliged to maintain the prohibition on defensive measures; it could adopt the option where defensive measures are not prohibited unless the shareholders of the companies choose to opt into adopting the prohibition. However, the Government clearly intended that the prohibition on defensive measures would continue to apply, which illustrates the entrenchment of the pro-shareholder choice stance in U.K.[195]

B. *Concepts of independence and disinterestedness*

In the line Delaware cases decided after *Unocal* and *Revlon*, defensive measures (including deal protections) made by truly disinterested directors are given more weight and the courts will give deference to such board decisions, whether such measures are evaluated under the *Unocal* or *Revlon* standard of review.[196] The case law has

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committees to stand for election each year and if any individual director has less than 75% of the votes, the chairman of the board will have to stand for re-election the following year).

[195] The U.K. Government stated that "important UK City and business stakeholders emphasized their support for article 9 [of the Takeovers Directive] and the principles underlying it". *See* DEPARTMENT OF TRADE AND INDUSTRY, COMPANY LAW IMPLEMENTATION OF THE EUROPEAN DIRECTIVE ON TAKEOVER BIDS: A CONSULTATIVE DOCUMENT (2005), at 26-27. Article 9 of the Takeovers Directive provides, *inter alia*, that boards of offeree company (or target company) must obtain the prior authorization of its shareholders for taking any action, other than seeking alternative bids, which may result in the frustration of the bid.

[196] *Supra* note 117 (discussing *Macmillan*).

emphasized that disinterestedness must mean free from managerial domination[197] and free from financial interest that is adverse to the corporation.[198] One question that arises is whether directors who have significant stock ownership or who are representatives of significant shareholders would disqualify them from being truly disinterested in takeover contests. Would the holding of stock mean that these directors are more likely to make decisions with the shareholders' best interests or with their own financial interests? This issue is becoming more important because of the trend in compensating outside directors in the form of stock and stock options[199] and also in view of the recent proposal to allow institutional shareholders to nominate directors on the board.

It has been argued that § 301 of SOX, [200] taken together with the listing rules which are adopted post-SOX, appear to imply that ownership or affiliation with the owner of a significant block of company stock would cast doubt on a director's independence. [201] However, the cases decided prior to the enactment of the SOX have taken the view that significant ownership of shares by outside directors not only does not qualify a director's independence but is in fact regarded as beneficial as such ownership

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[197] *Id.*

[198] Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

[199] *Supra* note 156 and accompanying text.

[200] Sarbanes Oxley Act of 2002 § 301 (codified at 15 U.S.C. § 78j-1(m)(3)(B)) requires, *inter alia*, that the audit committee of a listed company must comprise entirely of independent directors and such a person may not be an affiliated person of the company or its subsidiary. The SEC rules provides a safe harbor for shareholding under 10 percent but it also means that a director who owns or is affiliated with a stockholder who owns 10 per cent. or more of the company's shares may be regarded an affiliated person and would not be able to serve on the audit committee: see Standards Relating to Listed Company Audit Committees, Exchange Act (as added by Sarbanes-Oxley Act of 2002 § 301) Release No 33-8820, 34-47654 68 Fed. Reg. 18,788 (Apr. 16, 2003), at II(a)(3).

[201] *See* William B. Chandler III and Leo E. Strine Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State* 14 (New York University Center for Law and Business, Working Paper No. CLB 03-01; University of Pennsylvania Law School, Institute for Law and Economics Research Paper No. 03-03, Feb. 26, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=367720 (last visited Jun. 1, 2009) (discussing the attitude towards equity ownership by independent directors under the statutes and listing rules).

aligns the interests of the directors with the shareholders.[202] While there is no direct conflict as SOX determines independence for the purpose of audit committee only and case law determines disinterestedness for purpose of determining the validity of defensive measure in question, there appears to be a shift in current thinking that significant ownership or affiliation with significant shareholders may qualify a person's independence or disinterestedness. In particular, if equity compensation constitutes a significant proportion of an outside director's net wealth, it could compromise her opportunity costs of leaving the board.[203] For example, an outside director may decline to challenge a CEO's decision to merge with another party if she is promised a board seat in the merged entity, to ensure that her flow of compensation is not compromised.

It is an open question whether the Delaware courts will reconsider the concept of independence or disinterestedness in light of these developments in determining whether deference should be given to board decisions.[204]

C. *Change of Control Clauses*

Will the 1% equity value ceiling on termination fees and their equivalents in U.K. continue to be appropriate? It is suggested that this ceiling should be reconsidered in light

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[202] *E.g. Unitrin supra* note 104 at 1380-1381 (the Delaware Supreme Court rejecting the argument that Unitrin's outside directors, who are also substantial stockholders, would not vote like other stockholders in a proxy contest, i.e. in their own best economic interests, and holding that stockholders are presumed to act in their own best economic interests when they vote in a proxy contest).

[203] *See* Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors* 105 Mich. L.R. 1677 (2007) (arguing that equity compensation of outside directors has limitations).

[204] In the U.K., shareholding of a non-executive director (that is, a director who is not in management or represents management) that represents a significant portion of his wealth is regarded as undesirable: see *See* DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS (2003), para.12.26.

of the fact that the amount may under-compensate the bidder even in respect of out of pocket deal costs. As pointed out in Part IV(B)(3) above, the increasing use of change of control covenants put in place in bond and loan documentation in companies means that the bidder has to make arrangements for credit lines to repay such debts and refinance such loans at higher rates. Companies which have been identified as having change of control covenants in their bond or loan agreements include companies not only in the U.S. but also in the U.K.[205]

Accordingly, a more appropriate reference point is the transaction value (rather than the equity value), which will be the total amount that the acquirer needs to pay (either in cash or in kind) in order to acquire the target. This would take into account the bidder having to re-finance the debt of the target upon the successful completion of the takeover. Otherwise a system which puts the 1% cap on equity value under-compensates the acquirer in certain circumstances. The sensitivity shown to the difference between equity and enterprise value is reflected in the Delaware case law. For example, in *Toys "R" Us*, the court drew the distinction between the equity value and the transaction value, which was the total debt and equity that the private equity buyer needed to pay in order to acquire the target.[206]

D. *Which method is preferable?*

1. *Promotion of hostile versus friendly bids*

[205] For U.K. companies, see Paul J. Davies, *Moody's Warns on Change of Control Clauses*, FIN. TIMES, Apr. 25, 2007.

[206] *Toys R "Us"*, 877 A.2d 975 at 997.

If hostile bids are to be encouraged either because the mere threat of hostile bids serve as a disciplinary effect on managers and/or such bids encourage the acquired assets to be utilized more efficiently, it could be argued that deal protections should be more tightly regulated. Termination fees and lockups make the hostile bids more difficult to succeed (due to the diminution in target value) and they prevent the would-be hostile bidder from even making a bid. One important effect of the pro-shareholder takeover regulation in U.K. is that its target companies attract much more hostile bids than U.S., even after adjusting for the respective seizes of the two economies.[207] Even though the Takeover Code has some aspects which make it more expensive (and less flexible) for a bidder such as the rules on mandatory bid[208] and for a bidder to ensure that equality of treatment of all shareholders of the same class,[209] overall, its restrictions on deal commitments with preferred bidders and its overall ban on defensive tactics make it easier for hostile takeover bids to be launched and succeed.

Historically, hostile bids play an important role in corporate law as they are seen as serving as a disciplinary effect on the managers; in contrast, friendly mergers are seen as synergistic. [210] Promoting hostile bids is in a way similar to promoting auctions, where the goal of the target management is to get the highest price for the shares. The arguments in favor for having a rule that favors hostile bids or auctions is that there is no

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[207] See Armour & Skeel, *supra* note **Error! Bookmark not defined.** at 1741.

[208] TAKEOVER CODE, Rule 9.

[209] TAKEOVER CODE, General Principle 1.

[210] *See e.g.* Randall Morck, Andrei Shleifer and Robert W. Vishny, *Characteristics of Targets of Hostile and Friendly Takeovers*, CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (Alan J. Auerbach ed., 1988) [hereinafter CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES] 101, 104-26 (showing the empirical evidence that hostile takeovers are disciplinary and friendly takeovers are synergistic).

other perfect substitute for takeovers in order to prevent the management from acting in a self-interested manner. Shareholders' derivative actions have their own limitations[211] and post-Enron and Worldcom era, remuneration of management that is reliant on performance based compensation actually led to perverse effects.

However, it is not possible from the evidence to conclude that a rule whose effects lead to more hostile bids or more auctions is necessarily more welfare enhancing than a rule which leads to more friendly bids for the following reasons. First, the distinction between friendly and hostile bids is not so clear-cut. Academic commentators have argued that it could be a matter of negotiating strategies for a bidder.[212] A bid may initially be rejected by the target board for inadequacies in the price but the target board eventually changes its mind when the bidder raises the price.

Second, the evidence does not demonstrate convincingly that hostile bids are overall more welfare enhancing than friendly bids. While hostile bids have been shown to be positively correlated to takeover premium realized by target shareholders, the evidence is not clear whether such resources are in fact re-distributed to the target shareholders at the expense of acquirer shareholders in the long term.[213]

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[211] For a discussion on the demerits of derivative action, see Arad Reisberg, DERIVATIVE ACTIONS AND CORPORATE GOVERNANCE (Oxford Univ. Press, 2007), at 47-50 (including derivative actions are costly, they generate other agency costs and they deter legitimate risk-taking).

[212] *See* G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder*, 55 J. FIN. 2599 (2002).

[213] *E.g.*, *see* Christian Tuch & Noel O'Sullivan, *The Impact of Acquisitions on Firm Performance*, 9 INT'L J. MGT. REV. 141 (2007) at 152-155(reviewing the empirical research on the correlation between mood of takeover (whether hostile or friendly) on performance and finding that the research suggests hostile takeovers improve firm profitability and shareholders in single hostile bidders fare best but there is no identification of significant positive returns for bidders).

2. *Costs of strict shareholder choice model*

One of the arguments for a managerial primacy model is that blanket prohibition on defensive measures creates externalities for the other stakeholder groups, especially employees. Shleifer and Summers have argued that companies have implicit long-term contracts with employees,[214] including rewarding the employees well if they do their jobs well and are productive. These contracts are not legally binding because the expectations are too undefined to be given legal protection; however, such contracts are beneficial to both the employers and employees. If a target company is acquired, the new management has no moral obligation to honor these implicit contracts (even if the acquisition is undertaken other than for management under-performance) and has no qualms in breaching the implicit contracts upon the successful takeover by either cutting or reducing their above-market wages, being the deferred portion of their remuneration. Once employees become afraid of the consequences of takeovers, they will become reluctant to invest in firm specific human capital, such as the acquisition of specialized skills, which will reflect in lower output levels. The result is that these takeovers are merely rent-seeking and not value-creating exercises; any increase in performance is a result of the transfer of wealth from stakeholders to employees. Yet, the new management has every incentive to breach the implicit contracts in order to realize immediate cash-flow which appears to be attractive, at the expense of longer-term gains.

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[214] Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, *supra* note 210, ch. 2.

An implication of the argument is that directors can and should take into account stakeholders' interests as part and parcel of considering the long-term interests of the company (even if they do not serve the short-term interests of the company). Accordingly, by this argument, target management should have the discretion to be able to put up takeover defenses that will ensure that the implicit contracts would not ultimately be breached post-acquisition. These defenses may include the entry into deal protections with a favored bidder which has promised not to breach the implicit contracts.

Another issue that arises is the importance of encouraging business strategies that will build long-term shareholder value and be compatible with corporate social responsibility ("CSR").[215] In *Paramount*, the Delaware Supreme Court suggested that directors may consider the impact of constituencies, other than shareholders.[216] In the 1980s, many states in U.S. (though not including Delaware) enacted stakeholder constituency statutes.[217] Most of these statues permit directors to consider the interests of the other constituencies when making decisions.[218] While the pursuit of such strategies may not directly translate to financial performance, they are seen as essential as building long-term value. On the face of it, a regime which encourages hostile takeovers encourages managers to engage in short-termism and is not conducive to strategies that build stakeholder relations over a longer term. Conversely, a regime which allows target board managerial discretion allows them to take into account on the interests of other

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[215] *E.g.* HER MAJESTY'S GOVERNMENT, CORPORATE RESPONSIBILITY REPORT (2008), available at http://www.berr.gov.uk/files/file50312.pdf (last visited Jun. 2, 2009).

[216] *Paramount* 571 A.2d at 1153.

[217] *E.g.* Pennsylvania enacted the first constituency statute in 1983 which permits the directors to consider non-shareholder interests in discharging their duties; *see* 15 PA. Const. Stat. § 1716(a).

[218] *Id*.

stakeholder groups in deciding whether to go ahead with a particular transaction with the bidder.

The empirical evidence on the effect of M&A transactions on wages and productivity levels in both U.K. and U.S. firms do not unequivocally suggest that takeover offers result in target shareholders are receiving value at the expense of employees. There is a study which shows that in the U.K., takeovers of British firms by U.S. acquirers has actually *increased* the wages of skilled and unskilled employees of these firms post-acquisition, though the issue as to whether such acquisitions are desirable would depend on the reasons are for the higher wages.[219] Another study shows that there is no support for the Shleifer and Summers' hypothesis, but rather workers and employees are locked into 'equal misery' resulting from the poor performance of the merged entity.[220] Other recent empirical studies involving leveraged buy-outs of British firms suggest results that are more consistent with the analysis by Shleifer and Summers.[221] The data on U.S. firms is also inconclusive; there is a study on manufacturing plans which show that wages and employment increase after ownership

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[219] Sourafel Girma & Holger Gorg *Evaluating the foreign ownership wage premium using a difference-in-differences matching approach,* 72 J. INT'L ECON. 97 (2007).

[220] Til Beckmann and William Forbes, *An Examination of Takeovers, Job Loss and the Wage Decline within UK Industry*, 10 EURO. FIN. MGT. 141 (2004).

[221] See Kevin Arness & Mike Wright, *The Wage and Employment Implications of Leveraged Buyouts in the UK,* 14 INT'L J. ECON. BUS. 179 (2007) (review of transactions over 1999 to 2004 on leveraged buyouts cases; for leveraged buyouts, the cases are divided into management buyins ("MBI") , where the new management team is recruited from outside the firm, and management buyouts, where the existing local management team assumes control; study suggests that the newcomers are more likely to breach implicit contracts of employments because MBIs display lower employment and wage growth. *See also* Aoife Hanley and Vasilios Zervos, *The Performance of UK Takeovers: Does the Nationality of Acquirers Matter?* 14 INT'L J. ECON. & BUS. 283 (2007) (research showing that there is dip in productivity immediately upon the conclusion of a takeover based on a study of 755 UK firms between 1990 to 1996, irrespective of whether the acquirer is U.K., US or from other jurisdictions.)

change.[222] However, another study reports declines in levels of employment and wages of non-production workers at manufacturing buy-outs.[223]

There is insufficient evidence to conclude whether either regime is better positioned to address CSR matters. The constituency statutes enacted in the 1980s are seen as the results of managers successfully lobbying to insulate themselves from the effects of takeovers, rather than attempts to protect employees and other stakeholders.[224] Also these constituency statutes do not go as far as allowing the stakeholders to enforce the duties imposed thereunder.[225] The empirical studies on the effect of these statutes on shareholder wealth is mixed.[226] A recent study shows a positive co-relation between anti-takeover devices and socially responsible actions.[227]

However, U.K. has more stringent requirements on mandatory disclosures by companies on CSR matters than U.S. [228] In the late 1990s and early 2000s, U.K.

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[222] Robert H. McGuckin & Sang V. Nguyen, *The impact of ownership change: a view from the labor markets* 19 INT'L. J. OF INDUS. ORG. 739 (2001).

[223] Frank R. Lichtenberg & Donald Siegel, *The effect of ownership changes on the employment and wages of central office and other personnel* 33 J.L. & ECON. 383 (1990).

[224] *See e.g.* Roberta Romano, *The Political Economy of Takeover Statutes,* 73 VA. L. REV. 111 (1987).

[225] These statutes do not grant employees standing to sue to enforce the duties imposed. *See* Mark G Robilotti, *Recent Development: Codetermination, Stakeholder Rights, and Hostile Takeovers: A Reevaluation of the Evidence from Abroad* 38 HARV. INT'L L.J. 636 (1997).

[226] *See* Note, *Sword or Shield: The Impact of Third Generation State Takeover Statutes on Shareholder Wealth* 57 Geo. Wash. Int'l L. Rev. 958 (1989) (finding that state takeover statute has a negative effect on shareholder wealth); *c.f.* Romano, The Political Economy of Takeover Statutes 73 Va. L.R. 111 (1987) (finding that takeover statute has no adverse effect on shareholder wealth).

[227] A recent empirical study in U.S. shows that firms with anti-takeover devices direct their attention to institutional stakeholders, such as the community and natural environment, and experience higher long-term shareholder value. It would suggest that when relieved from takeover threats, managers can undertake more socially responsible actions but the study acknowledges that there could be other explanations for the findings. *See* Aleksandra Kacpercyzyk, *With Greater Power Comes Greater Responsibility? Takeover Protection and Corporate Attention to Stakeholders* 30 STRAT. MGMT. J. 261 (2009).

[228] *See* Cynthia A. Williams and John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct* 38 CORNELL INT'L. L.J. 493 (2005) (discussing the mandated disclosures of social and environmental risks in U.S. and U.K.)

considered the link between takeover regulation and corporate governance as part of the wider corporate law reform and decided that instead of adopting a pluralistic, stakeholder model, it adopted an "enlightened" shareholder value concept. Accordingly, the newly enacted § 172 of the Companies Act[229] requires the directors to consider the interests of groups beyond shareholders, including employees' interests, when they exercise their decision-making powers in promoting the success of the company "for the benefit of its members as a whole". Presumably, since the Takeover Code was not amended as a consequence of the enactment § 172, the intention of the regulators is that in a takeover bid, the interests of the other stakeholders are to be considered only insofar as they serve the interests of the *present* shareholders (rather than future shareholders).[230] At the same time, the Companies Act mandates a business review disclosure of, *inter alia*, information about environmental matters, employees and social and community issues.[231] Such disclosure addresses the need for the market to be apprised of companies' CSR activities and enable shareholders and other stakeholders in making judgments on non-financial performance.[232]

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[229] For a discussion of s 172 of the U.K. Companies Act 2006, see Joan Loughrey, Andrew Keay and Luca Cerioni, *Legal Practitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance* 8 J. CORP. L. STUD. 79 (2008).

[230] Some support is found in THE COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY (London, DTI, Feb. 1999) U.R.N. 99/654 at 47-48. *See* also Johnston, *supra* note 63 (pointing out that it was regrettable that there was no further consideration as to the takeover reform after the Government's withdrawal of the Operating and Financial Review, *infra* note 232).

[231] U.K. Companies Act 2006, § 417.

[232] The original recommendation of the Company Law Review Steering Committee was for an Operating and Financial Review [hereinafter OFR] and regulations to that effect were promulgated. The OFR was to provide a check on the more inclusive directors' duties to promote the success of the company, taking into account other stakeholders' interests. However the OFR was abruptly withdrawn by the U.K. Government and replaced with a business review: see GOWER AND DAVIES, at 737-741. *See* also John Armour, Simon Deakin & Suzanne J. Konselmann, *Shareholder Primacy and the Trajectory of UK Corporate Governance* 41 BRITISH J. OF IND. RELATIONS 531 (2003) (arguing the importance of non-financial aspects of corporate performance to the market).

Given the conflicting empirical studies, no conclusion can be drawn as to whether the gains to shareholders outweigh the costs incurred by the employees when the implicit contracts are breached post-takeovers. Assessing the issue of whether takeovers impose other costs on social, environmental and other CSR matters is more difficult. U.K. legislation imposes the obligation on the directors for the consideration of, and disclosure of, CSR matters. It remains to be seen whether its approach in aligning shareholder value with the society as a whole, but without amending the Takeover Code, will be effective.

3. *Empirical studies on termination fees and lockups*

There are some limited empirical studies on the effects of termination fees and lockups in the U.S. transactions which suggest the following matters.[233] First, deals with termination fees are associated with higher completion rates and with lower probabilities of third party competition. Thomas Bates and Michael Lemmon have shown that deals with termination fees have higher completion rates.[234] A similar result in this respect is shown by the empirical study by Coates and Subramanian.[235] Timothy Burch finds that deals with stock lockup options discourage competition and are associated with higher completion rates. Micah Officer reports that termination fees are associated with higher

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[233] Canada has a rule similar to U.S. transactions and a recent study on the effect of termination fees are positively related to cash financing, disclosed expenses as a percentage of deal value, disclosure of operational synergies, the percentage toehold, family block shareholdings and weakly, CEO retention, suggesting show that such fees are more consistent with the explanation that target management agrees to such fees in the interests of the shareholders, rather than as a result of managerial self-interest. *See* Paul Andre, Samer Khalil & Michel Magnan, *Termination Fees in Mergers and Acquisitions: Protecting Investors or Managers*", 34 J. BUS. FIN. & ACCT. 541 (2007).

[234] Thomas W. Bates and Michael L. Lemmon, *Breaking up is Hard to do? An Analysis of Termination Fee Provisions and Merger Outcomes*, 69 J. FIN. ECON. 469.

[235] Coates and Subramanian, *supra* note 2 at 347-353.

completion rates but finds that there is only weak evidence indicating termination fees deter bid competition.[236]

Second, termination fees are associated with either larger or neutral effects on takeover premium and announcement period returns. Thomas Bates and Michael Lemmon and Officer show that the target firms with termination fees clauses have somewhat higher transaction premiums and announcement period returns. Timothy Burch finds that lockup options discourage competitive bidders but suggests that shareholders are not harmed by their use. In contrast, Coates and Subramanian find that "foreclosing lockups"[237] occur more often than suggested by earlier studies. They further find that higher premium is more likely with stock lockups but not with termination fees.

To the author's knowledge, there is no corresponding empirical study on the effect of termination fees in U.K. market. However, a recent study[238] evaluating the data on deal protections in Australia[239] show that the inducement fees in the Australian context (which has a similar rule as the U.K.) do not deter competitive bidding and are not correlated to deal completion and suggest that inducement fees have a detrimental effect on shareholder wealth (measured based on final bid premium and abnormal returns surrounding the bid announcement). The possible explanation given was that any beneficial effect of inducement fees is mitigated under a bright line rule. It is unclear if

[236] Micah S. Officer, *supra* note 177.

[237] "Foreclosing lockups" is a term used by Ayres. *See* Ayres, *supra* note 8.

[238] Larelle Chapple, Blake Christensen & Peter M. Clarkson, *Termination Fees in a "Bright Line" Jurisdiction,* 47 ACCT. & FIN. 643 (2007).

[239] In Australia, the recommended cap is 1% of the equity value. See AUSTRALIAN TAKEOVERS PANEL, GUIDANCE NOTE 7: LOCK-UP DEVICES (Dec. 2001, last issued in Nov. 2007). A break-fee exceeding 1% of the equity value will be examined by the Takeovers Panel to ensure that it is not anti-competitive or coercive.

these results can be extrapolated into the U.K. due to the fact that there are significant differences in the shareholding patterns between the two jurisdictions; Australian publicly traded companies have a much higher proportion of concentrated share ownership compared to U.K. publicly traded companies[240] and may be less reliant on deal protections granted by targets.

It is submitted that the empirical studies do not provide clearly that deal protections are best explained as supporting the efficiency contracting justification, rather than as a device on management entrenchment, for the following reasons. First, while the empirical studies[241] show that termination fees are positively associated with shareholder wealth and takeover returns, which support the efficiency contract justification, they also show that takeover competition is truncated and that they are associated with higher completion rates, which suggests agency costs.

Second, many of the studies rely on data found in Thomson Financial Securities Data's SDC Platinum Worldwide Mergers & Acquisitions Database ("Thomson M&A database"), rather than data directly from the SEC filings of the companies. Recent work from Aura Boon and Harold Mulherin has shown that the data from Thomson M&A significantly under-reported the existence of termination fees in U.S. deals.[242]

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[240] *See* Alan Dignam, *Transplanting UK takeover culture: The EU Takeovers Directive and the Australian Experience*, 4 INT'L J. OF DISCLOSURE & GOVERNANCE 148 (2007).

[241] *See* Bates & Lemmon, *supra* note 234; Officer, *supra* note 177.

[242] Audra L. Boone & J. Harold Mulherin, *Do Termination Fees Truncate the Takeover Bidding Process*, 20 REV. FIN. STUD. 461 (2007).

Third, most of the analyses have focused on the presence of the termination fee in the friendly transactions. However, the empirical studies by Bates and Lemmon and Officer on U.S. transactions, other than the study by Coates and Subramanian, do not specifically examine the relation between the magnitude of termination fees as compared to the deal completion rates, probabilities of third party competition or takeover transaction premium. These studies point to the fact of the presence of the termination fees or lockups but not to the size. Accordingly, it is submitted that the current empirical evidence does not justify an overhaul of the system of takeover regulation of deal protections.

VII. CONCLUSION

This paper demonstrates that despite the apparent similarities in the shareholding ownership structures in the U.S. and U.K., there are significant differences in the regulation of deal protections in the two jurisdictions. The bright line rule prohibiting most types of termination fees and their functional equivalents in the U.K. is the product of a regime whose publicly traded companies were, until recently, dominated by domestic institutional shareholders which have influenced the development of a shareholder-centric model. In contrast, the concentration of institutional shareholdings in U.S. occurred at a later time and the institutional shareholders have not been able to significantly influence the development of takeover regulation; such development was left to Delaware case law. The different processes of takeover regulation also result in the differing impact in relation to the wasted transaction costs; the bidder's anticipated

transaction costs which would be wasted if the transaction does not close are likely to be higher in the U.S. than in the U.K.

This paper argues the despite the recent change in the shareholding patterns in U.S. and U.K., the existing regimes in approaching the issues relating to defensive measures, including deal protections, in the two jurisdictions are unlikely to change fundamentally. However, this paper raises two developments which may lead to a more modest review of the substantive rules. In the U.K., the increase in the use of change of control clauses raises the question as to whether the ceiling of 1% equity value on termination fees under-compensates the bidder, even as to its direct transaction costs. In the U.S., the open question is whether in the light of recent regulatory development, significant stock ownership, or affiliation to significant shareholders, by outside directors, would impact their independence and disinterestedness in assessing defensive measures under Delaware law.

Finally, despite the differences in the two systems of regulation, the analysis is that there is insufficient evidence to conclude that either the U.K.'s approach or the U.S. approach is superior either in relation to encouraging hostile bids or in not imposing other externalities. One remaining question is whether companies in either jurisdiction are better positioned to address CSR issues. U.K. has chosen to address CSR through the formulation of a duty on the board to consider the stakeholders' interests and to disclose its CSR practices to the market. Further research will be required as to its approach in

aligning shareholder value with the society as a whole, but without amending the takeover regulatory framework, will be effective.

Table 1 (M&A deals announced in 2006, 2007 and 2008)[243]

	(1)	(2)	(3)	(4)	(5)
Location of target	**All M&A announced**	**Hostile and Unsolicited**		**Friendly**	
	Number	**Number**	**% of (1)**	**Number**	**% of (1)**
U.S.	**2361**	**90**	**3.8**	**2278**	**96.5**
U.K.	**844**	**41**	**4.9**	**733**	**86.8**

Source: Thomson Financial *SDC Platinum* database

[243] Table 1 reports figures on M&A activity from 2006 to 2008 (inclusive) taken from Thomson Financial *SDC Platinum*, a subscription based service. Column (1) shows all of the MA&A transactions announced during this period for which the target firm is publicly traded located in the U.S. and U.K. respectively. Columns (2) and (3) show the number and percentage of transactions that were hostile or were unsolicited. Column (4) and (5) show the number and percentage of transactions that were friendly. *SDC Platinum* characterizes the deals as hostile, friendly, neutral and unsolicited.