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THE ILLUSION OF IMPORTANCE: RECONSIDERING THE UK'S TAKEOVER DEFENCE PROHIBITION

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Abstract This article considers the significance of the UK Takeover Code's non-frustration prohibition. It asks to what extent the prohibition actually prevents post-bid, director-controlled defences that would not have been, in any event, either formally prohibited by UK company law without shareholder approval or practically ineffective as a result of the basic UK company law rule set. It finds that there would be minimal scope for director-deployed defences in the absence of the non-frustration prohibition, and that, in the context of UK company law, such defences have limited scope to be deployed for entrenchment purposes. Furthermore, this minimal scope for board defensive action would, in order to be compliant with a director's duties, require a pre-bid, shareholder-approved alteration to the UK's default constitutional balance of power between the board and the shareholder body to allow corporate powers to be used for defensive effect. In light of this conclusion the article looks for a rationale to justify denying shareholders the right to make this limited and potentially beneficial defensive election. It concludes that no persuasive rationale is available and that the prohibition is unnecessary and without justification.

I. INTRODUCTION

General Principle 3¹ together with Rule 21² of the United Kingdom's Takeover Code³ circumscribe the types of unilateral action that a listed company's board of directors may take when subject to, or about to be subject to,⁴ an unsolicited takeover bid. The principle set forth in General Principle 3

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¹ General Principle 3 provides that 'the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid' Takeover Code (2006), B1.

² Rule 21.1(a) now sets forth the general non-frustration prohibition previously contained in the General Principle 7 of the previous edition of the Takeover Code. Rule 21.1(b) sets forth specific prohibitions, for example, on the issue of authorized but unissued shares without shareholder approval (Takeover Code (2006) I 14).

³ The eighth edition of the Takeover Code was published on 20 May 2006 <<http://www.thetakeoverpanel.org.uk/new/codesars/DATA/code.pdf>>.

⁴ The non-frustration prohibition applies where an offer has been made but also 'where the company has reason to believe that a bona fide offer might be imminent'. For simplicity's sake this article uses the term 'bid' to cover both actual and such imminent offers. This prohibition does not extend to defences put in place prior to any bid having been made.

and Rule 21 is known as the non-frustration principle and effectively limits post-bid defensive board action to persuading shareholders to reject the bid, lobbying regulatory competition authorities and searching for a more favourable suitor, known colloquially as a 'white knight'.⁵

This regulatory approach to takeover defences is the distinctive centrepiece of the Takeover Code and is viewed by many as the model for takeover defence regulation.⁶ There is considerable support in UK academic, practitioner, and business circles for the non-frustration principle.⁷ The failure of the European Union's Takeover Directive to require that all Member States implement a non-frustration approach was greeted with disquiet in these circles.⁸ Support for the principle is premised on several familiar rationales. First, shareholder sovereignty: shareholders should be able to decide whether or not to sell their shares. Paternalistic concerns about uninformed apathetic shareholders are misplaced in a bid context: collective action problems are less acute as individual shareholders have strong incentives to determine whether the offer price is appropriate. Second, the non-frustration principle ensures an active market for corporate control which reduces the scope for management to act in their own interests even prior to a bid and facilitates the replacement of inefficient or incompetent management. Third, a prohibition on defences controls the acute agency cost problem generated by the bid itself: the managers of a company subject to a bid are exposed to loss of office and accompanying benefits of control and may, therefore, deploy defences to protect their own interests and not for any value-enhancing purpose. Fourth,

⁵ P Davies, 'The Regulation of Defensive Tactics in the United Kingdom and the United States' in KJ Hopt and E Wynmeersch (eds), *European Takeovers: Law and Practice* (Butterworths, London, 1992) 200.

⁶ See High Level Group of Company Law Experts Report on Issues Relating to Takeover Bids (2000) (the Winter Report) (the report was requested by the European Commission), rejecting any scope for the board to take defensive measures. See also T Baums and KE Scott, 'Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany' (2005) 53 *American Journal of Comparative Law* 31, 74.

⁷ See, eg, TI Ogowewo, 'Rationalising General Principle 7 of the City Code' (1997) 1 *Company Financial and Insolvency Law Review* 74, 80, arguing that 'it is fundamental to the efficient working of the market for corporate control that shareholders should be able to sell their shares without management frustrating action'; Ben Pettet notes that 'takeover defences in the UK are heavily circumscribed by what seems to be a prevailing attitude among city institutions and business that hostile bids are beneficial and even if not actually encouraged, they should not be stifled' (B Pettet, *Company Law* (2nd edn, Longman, Harlow, 2005) 398); Company Law Committee of the Law Society, *Response to the Department of Trade and Industry Consultation Document (Apr 1996) on a proposal for a Thirteenth directive on Company Law concerning takeover bids* (memorandum series no 329, June 1996) paras 1.5 and 9.3; J Plender, 'Europe Feels the Toxic Effect of Corporate Nationalism' *Financial Times* (London, 6 Apr 2006) referring to US takeover regulation as highly toxic compared to the UK approach which enables a control market which is fair to shareholders.

⁸ M Gatti, 'Optionality Arrangements and Reciprocity in the European Takeover Directive' (2005) 6 *European Business Organization Law Review* 553, 561 notes that 'if we analyze the main reason why the [Directive on Takeover Bids] created so much dissatisfaction among the experts, we observe that its political failure is ascribed to the fact that the board neutrality rule is not binding'. See also D Dombey, 'EU reaches takeover code compromise' *Financial Times* (London, 28 Nov 2003) 1; Editorial, 'Concerns about the Lamfalussy approach: but EU member states are to blame for weak financial laws' *Financial Times* (London, 1 Dec 2003) 18.

defences can get in the way of efficient combinations that generate synergies and reduce the cost of production. Consider, for example, the comments of the High Level Group of Company Law Experts established by the European Commission to look at takeover regulation in 2001 who concluded that:

Any regime which confers discretion on a board to impede or facilitate a bid inevitably involves unacceptable cost and risk...defensive mechanisms are often costly in themselves, apart from the fact that they deny the bidder the opportunity to create wealth by exploiting synergies after a successful bid. Most importantly management are faced with a significant conflict of interests if a takeover bid is made ... their interest *is* in saving their jobs and reputation instead of maximising the value of the company for shareholders. Their claims to represent the interests of shareholders or other stakeholders are likely to be tainted by self-interest. Shareholders should be able to decide for themselves (emphasis added).⁹

This consensus about the value of the non-frustration principle and the destructive potential of takeover defences contrasts sharply with the parameters of the takeover defence debate amongst scholars, practitioners and business persons in the United States. Under the corporate law of most US states, takeover defences which provide management with considerable discretion to resist if not unequivocally prohibit a bid are lawful and commonplace.¹⁰ The primary initial response by corporate law scholars to the deployment and court approval of takeover defences in the 1980s was to view these defences through the lens of managerial self-interest.¹¹ This academic consensus contrasted with a practitioner consensus that viewed takeover defences as a mechanism for protecting shareholder value and other stakeholders by protecting the company's longer term strategic interests.¹² The US academic consensus has, however, changed radically since these earlier encounters. The contemporary US debate takes place within the narrow parameters of a *general acceptance* that takeover defences should be available and that their availability *potentially* benefits shareholder value. Within these parameters a strident debate takes place about the extent to which the board should be shielded from effective court review of the deployment of these defences and about the amount of time a board should be able to resist a bidder's advances. Today in the United States a regime based upon Rule 21 would attract few proponents, even amongst those who are seen as academic champions of shareholder rights.¹³

⁹ Winter Report (n 6) 21.

¹⁰ See, eg, *Unitrin v American General Corp* 651 A.2d 1361 (Delaware, 1995).

¹¹ See, eg, FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, 1991) noting at 162 that 'resistance is the phenomenon of interest'.

¹² See, eg, M Lipton, 'Corporate Governance in the Age of Finance Corporatism' (1987) 136 *University of Pennsylvania Law Review* 1 (Martin Lipton is a Senior Partner at Wachtell, Lipton, Rosen, and Katz and creator of the poison pill which is discussed at n 23 below).

¹³ See, eg, L Bebchuk, 'The Case Against Board Veto in Corporate Takeovers' (2002) 69 *The University of Chicago Law Review* 973, 1027, arguing against board veto but accepting that a poison pill should remain in place for 'a period reasonably sufficient for . . . exploring and preparing alternatives for shareholder consideration'.

There are two central insights that have transformed the US debate. The first is that although takeover defences may be used to entrench management they also have several potentially positive functions, depending on defence type. First, they facilitate an undistorted shareholder vote on the proposed transaction.¹⁴ Secondly, once the company is placed in play they allow the board to determine a sale strategy and control the sale process: a controlled sale process is likely to result in a higher premium than an uncontrolled auction.¹⁵ Thirdly, related to this, they give the board more time to identify other potential value-enhancing restructuring or third party purchaser options. Fourthly, they can prevent uninformed and uninformed shareholders from selling their shares for less than they are worth.¹⁶ Fifthly, they give the board greater bargaining power which may, depending on the particular circumstances, enable them to obtain a price that exceeds the board's reservation price and to extract a greater share of any deal synergies.

The second insight is that the effectiveness of any tailored takeover defence, with regard to both its ability to entrench management as well as the positive functions outlined above, is dependent upon the background set of very basic corporate law rules and the extent to which those basic corporate law rules are default or mandatory rules. These basic rules include: rules governing the appointment and removal of the board of directors; the amendment of constitutional documents; the calling of shareholder meetings; and agenda-setting for any such meetings. The functional effectiveness of a takeover defence depends on its interaction with these basic rules. The apparently potent potential of a takeover defence in one rule setting could be emasculated by a different set of background rules. A different rule setting could disable any entrenchment functionality but maintain a defence's effectiveness as a delay or sale-control mechanism.

This article is an inquiry into how these insights affect our understanding of the significance of and the justification for the UK's non-frustration prohibition. This inquiry requires that we posit a UK legal world without Rule 21.¹⁷ The article asks: what would be the scope for directors to deploy, and for what purposes could they deploy, takeover defences once the bid has been made if there were no Rule 21 prohibition? Using the *board controlled*¹⁸ takeover defences found in the United States as a hypothetically complete control set of

¹⁴ *ibid* 981. See also n 133.

¹⁵ M Kahan and EB Rock, 'Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment' (2003) 152 *University of Pennsylvania Law Review* 473, 477 arguing that this effect of takeover defences has not been 'properly emphasized in the takeover literature'.

¹⁶ *Unitrin v American General Corp* (n 10).

¹⁷ This contrasts with much of the existing scholarship on Rule 21 that has looked at the availability of pre-bid defences that do not require any post-bid board action such as multiple voting rights structures and placing shares with a friendly third party prior to any bid. See, eg, P Davies (n 5).

¹⁸ 'Board controlled' is used here to refer to both defences which give the board a discretion to apply them or to lift them once the bid has been made (whether put in place pre-or post bid) as well as to defences that involve post-bid corporate action that has a defensive effect.

defence types, the article considers the formal availability of such takeover defences in the UK, their compliance with UK directors' duties and, to the extent that they are formally available and duty-compliant, their functional effectiveness when considered together with UK company law's background rule set.

The article argues that without Rule 21 the scope for post-bid defensive action by the board would be minimal. *All* mechanisms designed by US companies *purely* for defensive purposes¹⁹ which enable the board to control the defence during the bid would either be unavailable or practically ineffective. Even without Rule 21 any post-bid corporate action intended to have a defensive effect requires either specific contemporaneous approval or pre-bid adjustment to the constitutional balance of power between the board and shareholders, to authorize corporate powers to be used for defensive purposes. Furthermore, the article argues that when made available to the board the scope to exploit this minimal defensive discretion for entrenchment rather than value-enhancing purposes is constrained by UK company law's basic mandatory rules and is much more limited than in the United States. Accordingly, Rule 21 denies UK shareholders the opportunity to elect to exploit aspects of the positive functionality of takeover defences (from a shareholder value perspective) but it does not protect them from the negative entrenchment effects of available takeover defences as these effects are neutralized in any event. In light of these conclusions the final part of the article considers whether a persuasive rationale for Rule 21's continued existence can be articulated. The article submits that UK regulators and proponents of Rule 21 have failed to articulate a plausible rationale.

II. TAKEOVER DEFENCES IN THE ABSENCE OF THE NON-FRUSTRATION PROHIBITION

In contrast to the UK's prohibition on post-bid defensive action by the board, US state corporations laws provide both generally applicable board-controlled takeover defences, which companies may opt-out of, and permit the use of company-specific, board-controlled takeover defences. In Delaware, for example, the Delaware General Corporation Law provides a statutory takeover defence in the form of its Business Combination Statute (discussed in detail below) and the Delaware courts have permitted companies to develop and deploy takeover defences post-bid provided that they are proportionate to the threat which the bid poses to corporate policy and effectiveness.²⁰ This defensive freedom has resulted in a range of creative defences devised by companies' legal and business advisors. Within the confines of the proportionality

¹⁹ eg poison pills or business combination statutes. See text to nn 23–36.

²⁰ *Unocol Corp v Mesa Petroleum Co* 493 A.2d 946 (Delaware, 1985).

constraint,²¹ the US experience of defensive measures provides us with a useful and arguably complete control set of board-controlled defence types.

This section outlines the primary US board-controlled defence types and asks to what extent they would be available and/or practically effective in a UK legal environment that did not contain the Takeover Code's non-frustration prohibition. The section addresses this question in three parts. First, it describes the takeover defence types and considers their formal availability; that is, does UK company law offer the tools necessary to put such defences in place? Secondly, it asks whether the use of the formally available defences is compatible with directors' duties owed to the company? Thirdly, it asks whether, even if defences are formally available and compliant with directors' duties, the context of UK company law's basic rule set enables or strips them of their effectiveness in practice. Effective takeover defences (ETDs) are those defences that combine all three of these factors: they are formally available, duty-compliant and effective in practice.

A. US Defence Types and their Theoretical UK Availability

There are five takeover defence types²² in the United States which locate the power to exercise the defence following a bid at board level: first, defences put in place through the creative use of options to purchase the company's equity which are issued to existing shareholders; second, business combination defences provided either by the state corporation code or set forth in the company's constitutional documents; third, the restructuring of the company's equity and debt; fourth, the defensive effect of business decisions taken outside of the ordinary course of business; and fifth, tactical litigation designed to forestall or stop a takeover bid.

1. Shareholder rights plans: poison pills

The most important type of board-controlled US takeover defence is a shareholder rights plan. This defence involves warrants issued by the target company to existing shareholders to purchase equity in the target company (flip-in plan) or in the bidder should a successful bidder merge with the target (flip-over plan).²³ These are the infamous poison pill²⁴ defences. They are put

²¹ The proportionality constraint was significantly relaxed post-Unocal following the Delaware Supreme Court's decisions in *Paramount Communications, Inc v Time Incorporated* 571 A.2d 1140 (Delaware, 1990) and *Unitrin v American General Corp* (n 10).

²² This section does not set forth an exclusive list of possible defences, only those that involve post-bid board action without shareholder approval; that is, those defences caught by Rule 21.

²³ For a more detailed explanation of flip-in and flip over pills as well as a review of the initial approval of these devices by the Delaware Courts see JP Lowry, "Poison Pills" in US Corporations—A Re-Examination' [May 1992] *Journal of Business Law* 337.

²⁴ The term poison pill is sometimes used in UK debates as a general term for takeover defences, see, B Clarke, 'Regulating Poison Pill Devices' (2004) 4 *Journal of Corporate Law*

in place without shareholder approval by the issuance of the warrants as an interim dividend. The rights attached to these warrants are set forth in a shareholder rights plan adopted by the board. The warrants are attached to the shares and transferred with the shares prior to a triggering event. The warrants have no economic value until triggered by a hostile bidder. If such a bidder crosses a specified ownership threshold, which is typically between 10 and 20 per cent of the target's outstanding voting shares, *without* obtaining target board approval then the warrants give the existing shareholders (excluding the bidder) the right to purchase voting equity at, usually, a 50 per cent discount. The effect of the pill if triggered is to significantly dilute the bidder's existing shareholding in the target (flip-in plan) or the shareholders of the bidder itself following a subsequent merger (flip-over plan), resulting in a substantial transfer in value to existing target shareholders. Accordingly, no bidder would ever, and has ever, swallowed a pill. The shareholder rights plan provides that the board has the right to redeem the warrants. Until the board does so the tender offer will not be able to proceed. Importantly, in most US states a pill can be adopted at any time without the requirement to obtain shareholder approval even after a bidder has announced its intention to commence a tender offer.²⁵ Variations on the redemption provisions, that are not valid in all states, include provisions that prevent redemption for a time period following the announcement of the bid (a no-hand pill) and continuing director provisions that allow only the board members that held office at the time the pill was adopted to redeem the pill (dead-hand pill).²⁶

In the UK Rule 21 would not prevent putting a poison pill into place prior to any bid.²⁷ However, following the announcement of the bid and the bidders' request to redeem the pill, the board's refusal to redeem a pill would violate Rule 21 as it would amount to action that would frustrate the bid and prevent the shareholders from deciding on the merits of the offer. In theory, a pill could be put in place that has no board redemption provision, which would, therefore, require no action on the part of the board. However, it is highly unlikely that any company would attempt to put in place such a pill as it would deter any friendly bid if all shareholders could not be persuaded to relinquish the warrants.²⁸

Studies 51. This article adopts the US approach to this terminology where poison pill is used exclusively to refer to shareholder rights plans.

²⁵ *Unitrin v American General Corp* (n 10).

²⁶ No-hand and dead-hand pills are not permitted in Delaware (see *Carmody v Toll Brothers, Inc* 723 A.2d 1180 (Delaware, 1998) and *Quickturn Design Sys, Inc v Shapiro* 721 A.2d 1281 (Delaware, 1998)), however, dead-hand pills have been approved in Georgia (*Invacare Corp v Healthdyne Tech* 968 F Supp 1678 (ND Georgia, 1997)) and no-hand pills have been approved in Pennsylvania (*AMP v Allied Signal* No 98-4405 LEXIS 15617 (Pennsylvania, 1998)).

²⁷ See G Barboutis, 'Takeover Defence Tactics II: Specific Defensive Devices' (1999) 20 *Company Lawyer* 40, discussing the availability of pills in the UK prior to a bid.

²⁸ cf *Criterion Properties plc v Stratford UK Properties LLC* [2002] EWCA Civ 1783.

In the absence of the Rule 21 prohibition, poison pills would be theoretically possible under UK company law. Boards of directors of public companies are usually authorized to make interim dividends.²⁹ A warrant could be issued to all shareholders of the company as an interim dividend. As with a US poison pill, the rights attached to those warrants would be set forth in a shareholder rights plan. However, in order to issue such warrants the shareholders in a general meeting would have to provide the board with authority to allot the warrants.³⁰ In contrast to the US, therefore, the pill would only be available with pre- or post-bid shareholder approval.

An additional problem with regard to its availability arises from the terms of the United Kingdom Listing Authority's (UKLA) Listing Principle 5 which provides that for listed companies holders of the same class of shares be treated 'equally in respect of the rights attaching to such' shares. Following a triggering event the bidder would not be able to exercise the right to purchase shares at a discount. If the bidder was allowed to do so it would vitiate the defensive impact of the pill as there would be no bidder value-dilution. Arguably, this discriminates against the bidder. The strong case that a pill *does not* amount to a violation of the equal treatment principle would be as follows: the warrant provides a contingent right which is applicable to all shareholders equally; should a bidder-shareholder not comply with the conditions of that warrant it would not be exercisable; the inability of the bidder to exercise any warrant rights stems not from shareholder rights discrimination but from the bidder's own failure to comply with the warrant's conditionality. However, if the UKLA rejected this argument and viewed these devices as discriminatory they would be unavailable to UK listed companies.

2. *Business combination defences*

A business combination defence places limitations on the ability of a successful bidder to combine with the target company, through a merger or any type of asset disposition or lease, for a specified period following the completion of the tender offer if the bidder crosses a share ownership threshold without the approval of the incumbent board. Such a restriction inhibits a successful bidder from integrating and restructuring the target company and delays the realization of any expected synergies. For example, section 203 of the Delaware General Corporation Code provides for a threshold of 15 per cent of the outstanding voting stock of the corporation and for a three-year bar on any business combination.³¹ Post-completion, these restrictions may be waived

²⁹ Table A provides for interim dividends in Art 103.

³⁰ Section 80 of the Companies Act 1985 requires that the board is authorized by the shareholder to body to allot 'relevant securities', which are defined in s 80(2) to include 'any right to subscribe for, or to convert into any security into, shares of the company' (ss 549–51 CA 2006).

³¹ This restriction is inapplicable if following the completion of the transaction in which the bidder crosses the 15 per cent threshold the bidder owns 85 per cent of the disinterested outstanding voting stock of the company s 203(a)(2) DGCL.

only with board approval and the approval of two-thirds of the disinterested shareholders.³² As prior management may form a substantial block of the remaining shareholders this post-purchase approval may be unavailable. Furthermore, the inability to merge the target with the bidder or one of its subsidiaries prevents the bidder from squeezing out management ownership either through a short form or a long form merger.³³ No other compulsory purchase mechanism is provided by Delaware law.

Variations on the business combination defence are common in many public company constitutional documents, whether or not the applicable corporation law provides for such defences. The important difference between statutory business combination defences as compared to similar defences that can be set forth in a company's constitutional documents is that shareholder approval is not required to put them in place. The default position is their application. To disapply them the company must amend its constitutional documents to opt out. Opting out, however, is no longer an option once the business combination provision has been triggered.³⁴

In the UK there is no reason why such restrictions could not be placed in the constitutional documents at the IPO stage or, with shareholder approval, at any time prior to any takeover bid. Such provisions would prevent any post-completion asset sale or any merger or consolidation pursuant to a scheme of arrangement.³⁵ Rule 21 does not prevent the shareholders from amending the constitution to include such a provision. It would, however, prevent the board from refusing to disapply the business combination provision to a specific bidder, as such a refusal would deny the shareholders the opportunity to 'decide on the merits of the bid'³⁶ as a bidder would be unlikely to proceed until the defence is raised.

3. Restructuring defences

The third type of board-controlled defence is the restructuring defence, which generally involves both a distribution to shareholders through an extraordinary dividend or share buy-back coupled with, and often funded by, either a placement of a block of shares with a friendly third party or a substantial increase in the company's leverage. The restructuring response is likely to depend on the nature of the bidder. A highly leveraged bidder, such as a private equity

³² Section 203(a)(3) DGCL.

³³ A short-form merger takes place where a parent that owns at least 90 per cent of the voting shares of a subsidiary merges with that subsidiary (s 253 DGCL). All other mergers are long-form mergers (s 251 DGCL).

³⁴ Section 203(b)(3) DGCL.

³⁵ Section 425 CA 1985 (ss 895–9 CA 2006). In *re Oceanic Steam Navigation Company Limited* [1939] Ch 41, the court held that it could not sanction any arrangement or compromise (under ss 153 and 154 of the Companies Act 1929) which involved a transfer of assets where the memorandum did not include a power to 'sell or dispose of the whole or any part of the undertaking'.

³⁶ General Principle 3 and Rule 21.1(a) Takeover Code (2006).

bidder, will require the target's free cash flow to finance its own debt.³⁷ If prior to the completion of the bid the target's leverage substantially increases then free cash flow will be inadequate and a bid impossible. However, if the bidder is an industrial cash or equity bidder which would not be deterred by the additional leverage, the restructuring is likely to focus on preventing the bidder from obtaining effective control. The recent proposed defensive response by the Luxembourg-based steel company Arcelor following the hostile approach made by Mittal Steel is a simple example of the latter type of restructuring. The defensive proposal involved issuing shares to a friendly third party, Severstal, amounting to 32 per cent of the company's outstanding shares. The company also proposed to effect a share buy-back which would have increased Severstal's stake in the company to 38 per cent.³⁸ An equity restructuring defence is dependent on the company's ability to find and to be permitted to make an issue of shares to a friendly third party. A debt restructuring defence is dependent on the company being sufficiently cash rich to service a substantial increase in debt and being permitted to make a very large distribution.

There is much less scope for carrying out restructuring defences in the UK than in the United States. Taking Delaware as the US comparator, if the company has sufficient authorized share capital the board has the power to issue a substantial block of shares to a friendly third party. No shareholder approval is required.³⁹ However, if the company is listed on the New York Stock Exchange and the share issue amounts to more than 20 per cent of the outstanding voting shares of the company then shareholder approval is required.⁴⁰ Corporation statutes do not impose mandatory pre-emption rights and, although companies may of their own accord provide pre-emption rights, such provision would be unusual in US publicly traded companies.⁴¹ Delaware companies have considerable flexibility to make large interim dividends provided that the company was not insolvent prior to, or as a result of, the dividend.⁴² Companies may make dividends out of surplus,⁴³ which could include capital received for prior issues of shares in excess of the par value of those shares.⁴⁴ Nimble dividends out of the most recent year's profits may be made even though the company's cumulative losses exceed its profits.⁴⁵

³⁷ Assuming any financial assistance problems can be resolved (Part V, Chapter VI CA 1985; Part 18 Chapter 2 CA 2006).

³⁸ See 'Doubts on Arcelor's bear-hug strategy now the Luxembourg company faces governance issues' *Financial Times* (London, 31 May 2006).

³⁹ Section 161 DGCL.

⁴⁰ New York Stock Exchange Listing Manual, para 312.03(c).

⁴¹ B Black and JC Coffee, 'Britannia: Institutional Investor Behavior Under Limited Regulation' (1994) 92 *Michigan Law Review* 1997.

⁴² Delaware Fraudulent Conveyance Act (Delaware Code, Title 6, subtitle II, Chapter 13, s 1305).

⁴³ DGCL, s 170(a).

⁴⁴ DGCL, s 154.

⁴⁵ DGCL, s 170(a).

Directors are authorized to repurchase shares provided that it does not impair the capital of the company.⁴⁶ No shareholder approval is required. All repurchased shares may be retained as treasury shares unless retired and may be resold to a third party.

Compare this level of flexibility to the situation facing a UK company considering a restructuring defence (in the absence of Rule 21).⁴⁷ UK companies face considerable restrictions in issuing shares to friendly third parties without post-bid shareholder approval. Pursuant to current UK law, a board of directors can only issue shares to a third party if the company has sufficient authorized share capital, the shareholders have granted authority to allot the shares⁴⁸ and, if the shares are issued for cash consideration, the shareholders have disapplied their statutorily imposed mandatory pre-emption rights.⁴⁹ Public companies generally seek annual resolutions that grant authority to allot shares. Such a grant of authority usually specifies the type of share, for example, ordinary shares, and may be conditional or unconditional.⁵⁰ Even assuming a substantial and rolling grant of authority to allot shares,⁵¹ it is clear that institutional shareholders value their pre-emption rights and although they are willing to grant a waiver of pre-emption rights for issuances of up to 5 per cent of outstanding shares each year, which should not exceed more than 7.5 per cent in any three-year rolling period, they look dimly upon and will oppose more extensive waivers.⁵² Although the recent introduction of treasury shares may provide some companies with additional flexibility, the pre-emption regime applies to these shares as well.⁵³ In theory UK boards have some scope to avoid these restrictions as pre-emption rights are only applicable if the share issue is for cash only and contains no in-kind consideration.⁵⁴ Even an insignificant in-kind component would result in the avoidance of the pre-emption right regime. However, given that UK institutional investors value pre-emption rights, any attempt by companies faced with a control threat to

⁴⁶ DGCL, s 160. Capital here refers to the stated capital of the company which in many cases will only be the aggregate par value of the issued shares. If net assets post-repurchase are less than stated capital, capital will be impaired (B Manning and JJ Hanks, Jr, *Legal Capital* (3rd edn Foundation Press, Westbury, NY, 1990) 34).

⁴⁷ Note 3 to Rule 21 of the Takeover Code (2006) provides that interim dividends issued during the offer period which are not in the ordinary course of business may violate the non-frustration principle.

⁴⁸ Section 80 CA 1985 (ss 549–51 CA 2006). See G Barboutis, 'Takeover Defence Tactics II: Specific Defensive Devices' (1999) 20 *Company Lawyer* 40 discussing, amongst others, authority to allot and pre-emption rights in relation to share issues as a defence tactic.

⁴⁹ Sections 89 and 95 CA 1985. (ss 561, 570, 571 CA 2006). (The Companies Act 2006 abolishes authorized share capital, however, it leaves authority to allot and pre-emption rights in place).

⁵⁰ Section 80(3) CA 1985. (ss 549–51 CA 2006).

⁵¹ See, eg, Vodafone Plc obtained at its AGM in July 2006 authority to allot 9,000,000,000 ordinary shares amounting to 14.9 per cent of the capital of the company.

⁵² Preemption Group Principles, Principles 8 and 10. See n 164 for further detail.

⁵³ Section 94(3)(A) CA 1985 (s 560(2)(b) CA 2006).

⁵⁴ Section 89(4) CA 1985 (s 565 CA 2006).

avoid pre-emption rights by combined cash and in-kind consideration would most likely result in standard conditions being placed upon future grants of authority to allot shares that would prevent any other non pre-emptive defensive issues.⁵⁵

On the distribution side, UK regulation is again more restrictive. To be able to make a substantial interim dividend UK public companies must comply with the net-profits test which requires that total cumulative realized profits exceed total cumulative realized losses by the amount of the dividend⁵⁶ and the net assets test, which requires that net assets exceed, amongst others, share capital and any share premium by the amount of the dividend.⁵⁷ A restructuring defence which involves a substantial distribution will, therefore, only be available to companies who have a very healthy balance sheet. Any attempt to alter the balance of control by making the distribution through a share repurchase is not as readily available to boards of UK companies as boards are not authorized to make such repurchases without shareholder approval.⁵⁸

4. Business decisions with a defensive impact

This category of defence involves business decisions that may have been taken because of their defensive impact but which can also be characterized as business decisions which were taken on the basis of the decision's business merits rather than its defensive impact. Post-bid this could include the sale of a key business asset or division, which is colloquially known as a 'crown jewels' defence, as the bidder would not be interested in the company without this asset.

Post-bid, Rule 21 prohibits the sale or purchase of a material⁵⁹ amount of assets⁶⁰ or entering into any contracts which are not in the ordinary course of business.⁶¹ In the hypothetical absence of the non-frustration principle, the primary form of regulation of these types of defensive decisions would be through directors' duties, which is discussed in detail below. In addition to this, a listed company board's freedom to sell all or a substantial stake in one of the company's important assets or divisions is constrained by the Listing Rules' regulation of Significant Transactions. Pursuant to Listing Rule 10.5, if the transaction amounts to 25 per cent of the target's gross assets, or the prof-

⁵⁵ Section 80(3) CA 1985 (s 551(2) CA 2006) provides that any authority to allot 'may be conditional or subject to conditions'.

⁵⁶ Section 263 CA 1985 (s 830 CA 2006).

⁵⁷ Section 264 CA 1985 (s 831 CA 2006).

⁵⁸ Section 164 CA 1985 (off-market purchase: special resolution) (s 694 CA 2006); s 166 CA 1985 (market purchase: ordinary resolution) (s 701 CA 2006).

⁵⁹ The Takeover Code does not provide bright line rules to determine materiality, rather it provides guidelines for the Panel to take into account in determining whether a transaction involves a material amount. These involve comparing the value and profitability of the assets against the target's market capitalization, its assets and profitability (note 2 to Rule 21, Takeover Code (2006)).

⁶⁰ Rule 21.1(b)(iv).

⁶¹ Rule 21.1(b)(v).

its attributable to the assets represent 25 per cent of the profits of the target, or the consideration is 25 per cent of the target's market capitalization,⁶² then the transaction is classified by the Listing Rules as a Class 1 transaction which must be conditional upon, and cannot be carried out without, shareholder approval.⁶³ This contrasts with Delaware law where shareholder approval is required for a disposal only when it amounts to the sale of 'all or substantially all' of the company's assets.⁶⁴

5. Litigation

In the United States defensive litigation by the target is a familiar aspect of contested takeover bids. Litigation is usually based on the bidder's failure to comply with the disclosure obligations set forth in sections 13(d) and 14(d) of the Securities and Exchange Act 1934 and the rules promulgated thereunder.⁶⁵ Target companies have commonly been granted private rights of action under these provisions by US courts.⁶⁶ In addition, targets sometimes commence private antitrust litigation under the Clayton Act on the basis that they will suffer an antitrust injury as a result of the takeover. There is, however, conflicting authority⁶⁷ on the extent to which targets have standing to bring such an action, with more recent authority suggesting that it would be difficult for targets to obtain standing.⁶⁸

Commencing litigation in the United States has the potential to serve two defensive objectives. First, it can create delay in the bid process thereby giving the board more time to prepare alternative defences or identify other bidders. Second, it may, depending on the nature of the claim and the merits of the case, halt the bid altogether. Since the approval of the poison pill in the mid-1980s⁶⁹ and clarification that a pill may be put in place after a bid

⁶² UKLA, Listing Rules, LR 10 (Significant Transactions), Annex 1 (the Class Tests).

⁶³ These provisions also regulate the issue of shares by a subsidiary that represents 25 per cent of the gross assets or profits of the target group, if the effect of such an issue of shares is 'equivalent to the disposal of 25% of the group' (Listing Rule 10.2.8).

⁶⁴ Section 271(a) DGCL.

⁶⁵ Section 13(d) of the Securities Exchange Act 1934 and Regulation 13D promulgated thereunder require disclosure on Schedule 13D when a shareholder acquires 5 per cent of a company's equity securities. Section 14(d) of the Securities and Exchange Act 1934 and Regulation 14D promulgated thereunder requires disclosure on Schedule TO at the time the tender offer is commenced.

⁶⁶ eg *Chevron Corp v Pennzoil Co* 974 F.2d 1165 (9th Cir, 1992).

⁶⁷ See *Consolidated Gold Fields PLC v Minorco, SA*, 871 F.2d 252, 258 (2d Cir, 1989) where the Second Circuit Court of Appeals granted standing and *Anago Inc v Techno Medical Products Inc* 976 F.2d 248 (1992) where the Fifth Circuit Court of Appeals held that the target did not have standing and stating that the decision in *Consolidated Gold* was inconsistent with the Supreme Court's decision in *Cargill, Inc v Monfort of Colorado, Inc*, 479 US 104 (1986).

⁶⁸ JM Jacobson and T Greer, 'Twenty-One Years Of Antitrust Injury: Down The Alley With *Brunswick v Pueblo Bowl-O-Mat*' (1998) 66 *Antitrust Law Journal* 273, 305 noting that 'most other courts have sided with the Fifth Circuit'; see, eg, *Moore Corporation Limited v Wallace Computer Services* 907 F Supp 1545 (Delaware, 1995) 1556.

⁶⁹ *Moran v Household International, Inc* 500 A2d 1346 (Delaware, 1985).

commences,⁷⁰ it is unlikely that litigation is used as a delaying device; the pill, particularly when combined with a staggered board,⁷¹ is likely to provide much more time than a temporary restraining order or a preliminary injunction.⁷² Furthermore, it is unusual for litigation to act as a ‘show stopper’.⁷³ In relation to disclosure litigation it is more common for the courts to require corrective disclosure.⁷⁴ In relation to antitrust litigation, if standing can be established, which as noted above is uncertain, and the merits of the case are strong then injunctive relief may temporarily⁷⁵ or even permanently put a stop to the tender offer. Such injunctive relief is, however, very rare. Since 1992 when the 5th Circuit of the US Court of Appeals held in *Anago Inc v Techno Medical Products Inc* that the target did not have standing, only one case⁷⁶ has granted preliminary injunctive relief in relation to an antitrust suit brought by the target.⁷⁷

Whereas in the United States the defensive implications of litigation have been rendered trivial by the ready availability of more powerful defences, to the extent that such other defences would not be available or are practically ineffective in the UK, litigation (in the absence of Rule 21) would have the potential to play a more important defensive role. To what extent would litigation be available to UK targets? The scope for tactical litigation under the *City Code on Takeovers and Mergers*, the predecessor of today’s *Takeover Code* (2006), was limited as the City Code did not have the force of law.⁷⁸ As the Panel performed public law duties, the Panel’s decisions themselves could be subject to judicial review. However, in *R v Panel on Take-overs and Mergers, ex parte Datafin*⁷⁹ the Court of Appeal clarified that the courts will not intervene in the Panel’s decision during the course of the bid, rather they will only intervene through declaratory orders providing guidance for future Panel decision-making. The legalization of the Code through the Companies

⁷⁰ *Unitrin v American General Corp* (n 10).

⁷¹ Typically, if a company has a staggered board only one-third of the directors are subject to re-election each year. In Delaware, for example, if a company has a staggered board the directors can only be removed during the course of their tenure for cause (s 141(d) and 141(k) DGCL).

⁷² A Fleischer and AR Sussman, *Takeover Defense* (Aspen Law & Business, Gaithersburg, 2004) 11–18.

⁷³ *ibid* 11–33 noting that ‘unless the bidder has seriously underestimated its legal exposure or overestimated its steadfastness a target cannot expect a vigorous litigation campaign to cause the bidder to abandon its offer’.

⁷⁴ *ibid* 11–13 referring to corrective disclosure as the more typical remedy.

⁷⁵ *Consolidated Gold Fields, PLC v Minorco, SA*, 871 F.2d 252, 258 (2d Cir, 1989).

⁷⁶ *Atlantic Coast Airlines Holdings, Inc v Mesa Air Group, Inc*, 295 F.Supp.2d 75 (DDC, 2003) (obtaining preliminary injunctive relief in relation to a consent solicitation and exchange offer).

⁷⁷ The relative unimportance of takeover litigation in the contemporary defensive setting is borne out by the paucity of US scholarship on takeover litigation since the late 1980s. For an excellent analysis of the earlier scholarship see T Ogowewo, ‘Tactical Litigation in Takeover Bids’ [2007] *Journal of Business Law* (forthcoming).

⁷⁸ For a review of the scope for defensive litigation pre- and post the Takeovers Directive (Interim Implementation Regulations) 2006 (which were superseded by Part 28 of the CA 2006 Act) see T Ogowewo, *op cit*.

⁷⁹ [1987] 2 WLR 699.

Act 2006⁸⁰ has not increased the scope for defensive litigation during the course of a bid based on Code violations. The Act provides that no person outside the Panel will be able to apply for injunctive relief⁸¹ and that there is no private law action for breach of statutory duty for 'contravention of a rule-based requirement or a disclosure requirement'.⁸²

Accordingly, Rule 21 plays no role in inhibiting *Code-related* litigation. To what extent, therefore, would there be scope for non-Code-related litigation in the absence of Rule 21? It was not until the Panel's statement in the *Consolidated Gold Fields* case,⁸³ where the UK target's US subsidiary obtained a US preliminary injunction for breach of US antitrust laws, that the Panel took a position on the implications of such litigation for the non-frustration principle. In this case, having determined that the litigation had a frustrating effect, they instructed Consolidated Gold Fields to discontinue the proceedings or obtain shareholder approval to continue the proceedings. Prior to this date there were only three cases in which the target brought an action for injunctive relief to prevent the bid going forward.⁸⁴ One of these cases, *Cartwright (Holdings) Plc v Newman Tonks Group Plc*,⁸⁵ was unsuccessful but also Code-related and therefore of no precedential value for contemporary targets. The other two, *Dunford Elliot v Johnston & Firth Brown*⁸⁶ and *Marina Development Group v Local London*, related to the use of confidential information about the target held by the bidder and resulted in the granting of an injunction at first instance in *Dunford Elliot*, which was overruled by the Court of Appeal, and a temporary suspension of the bid for five days in the case of *Marina Development*.⁸⁷

In the absence of Rule 21, it is submitted that the scope for non-Code-related defensive litigation would be insignificant. There is no private right of action under UK competition laws for UK targets. At best, targets would have the right to seek review of the Office of Fair Trading's (OFT) refusal to refer a matter to the Competition Commission.⁸⁸ However, unless the Competition

⁸⁰ Part 28 CA 2006. The Code was first given direct legal effect through the Takeovers Directive (Interim Implementation Regulations) 2006 which were superseded by Part 28 of the 2006 Act.

⁸¹ Section 955(3) CA 2006.

⁸² Section 956 CA 2006.

⁸³ Takeover Panel Statements 1989/7.

⁸⁴ See *Ogowewo* (n 7) 86.

⁸⁵ (1985) Unreported LEXIS. The plaintiff argued that provisions of the Code had contractual force between the parties as the Listing Rules contained an obligation to 'endeavor to observe the Code' and that the Listing Rules amounted to a 'nexus of agreement between the parties'. The Court thought this argument 'extremely thin' but not 'totally unarguable' for the purposes of obtaining a preliminary injunction. Pursuant to the 2006 Regulations such a claim would be code related and unactionable (ss 955 and 956 CA 2006).

⁸⁶ [1977] 1 Lloyd's Rep 505.

⁸⁷ Marina Developments discontinued the proceedings when information came to light that made it clear that there could have been no breach of confidential information. See 'Marina abandons injunction challenge' *The Independent* (London, 15 Feb 1989).

⁸⁸ Section 120 Enterprise Act 2002.

Appeal Tribunal rules otherwise, the effect of the original OFT decision is not suspended by this appeal which would allow the takeover to continue.⁸⁹ Whilst it is possible that, depending on their US business activities, UK targets could have resort to a private US antitrust suit, the legality of such suits is open to doubt and they are almost never successful. In addition, in the rare case where a bid for a UK company involves dual UK and US offers with the filing of tender offer disclosure documents under US securities laws,⁹⁰ there may be scope for defensive US disclosure litigation which may generate delay and corrective disclosure. Finally, it may be possible to obtain injunctive relief in relation to a breach of an obligation owed by the bidder to the target company, for example, in relation to confidential information. However, the small number of such cases prior to the Panel's 1989 statement suggests that such cases would be rare.

B. Defences and Directors' Duties

1. Improper purpose doctrine: a default constitutional rule of construction

Even if a takeover defence is theoretically available to a UK company's board of directors, the ability to deploy the defence will be dependent on its compliance with the board of directors' duties to the company. Non-compliance could expose the directors to a suit to force them to withdraw the defence and, where the company has suffered loss, directors could be required to compensate the company for such loss.⁹¹

To what extent are a director's duties compatible with action designed to deter or delay an unsolicited bid? Directors subject to English law have a fiduciary obligation to act in good faith in the best interests of the company. If defensive action is used to protect personal benefits of control then directors are in breach of this fiduciary obligation.⁹² In the leading cases dealing with the exercise of corporate power in control contests, the courts have, without reservation, accepted the bona fides of the directors.⁹³ Nevertheless, good faith has not been treated as a sufficient condition for legality. English courts have asked whether the exercise of a corporate power for defensive purposes

⁸⁹ Section 120(3) Enterprise Act 2002.

⁹⁰ eg Ford's purchase of Jaguar in 1989 involved concurrent US and UK offers ('Ford's Jaguar Offer Unconditional' *Financial Times* (London, 12 Dec 1989)).

⁹¹ The likelihood of suit will increase markedly upon the coming into force of the Companies Act 2006 which makes it easier for shareholders to bring a derivative suit (ss 260–4 CA 2006).

⁹² As Professor Sealy notes corporate action in bad faith or resulting from improper motives is sometimes included in the improper purpose doctrine, however, 'in this type of situation, the expression 'improper purpose' is simply a restatement in negative terms of the "bona fide in the interests of the company" test' (L Sealy, *Cases and Materials in Company Law* (OUP, Oxford, 2001) 310).

⁹³ See, eg, *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821 and *Hogg v Cramphorn Ltd* [1967] Ch 254.

is a legitimate exercise of the corporate power. The applicable doctrine is the improper purpose doctrine. Most commonly, the scope and operation of this doctrine is described through a theory about the delegation of powers which is analogous to the contractual constraints placed on company capacity and authority to act; the corporate contract delegates to the directors a set of powers, but they cannot misuse those powers for purposes that are not within the scope of the delegation.⁹⁴ In *Howard Smith Ltd v Ampol Petroleum Ltd* Lord Wilberforce asked whether a fiduciary power 'has been exercised for the purpose for which it was conferred' and held that 'although the exercise of such a power may be formally valid [it] may be attacked on the ground that it was not exercised for the purpose for which it was granted'.⁹⁵ The codification of directors' duties set forth in the Companies Act 2006 draws literally on Lord Wilberforce's approach providing that a 'director of a company must only exercise powers for the purposes for which they are conferred'.⁹⁶

There are two fundamental problems with this theory of power-specific delegation in the corporate context. First, in contrast to the drafting of state constitutions the drafting and formation of a corporate constitution is not the product of minuted debate about the purpose and intention of specific rules. In regard to most delegated powers there is no record that can enlighten a discussion about the proper purposes for which a specific power can be used. Indeed, most companies' powers are not the product of debate but of borrowed boilerplate, whether in the form of Table A or professionally tailored versions thereof. At most the intention could be said to provide the company with the powers it needs to run the business. Secondly, because the future is unpredictable the viability and effectiveness of a corporate contract is dependent on it being incomplete. No one can predict all the business problems and opportunities that will face the company in its future and the value-generating purposes for which the delegated powers may have to be used. Delegated corporate powers therefore do not contain *at any time*, at the time they were granted or at any point thereafter, an immanent, exhaustive list of proper purposes. Accordingly, any attempt by courts to assess original intent, to impute or to supplement purposive constraints is misdirected and hopeless.⁹⁷ The logical dead end of this theory of delegated power-specific proper purposes is quickly reached in *Howard Smith* when their Lord Wilberforce acknowledges that identifying valid purposes 'clearly cannot be done by enumeration, since the variety of situations facing directors of different types

⁹⁴ J Farrer and B Hannigan, *Farrer's Company Law* (4th edn, Butterworths, London, 1998) 389: 'the first step then is to construe the article conferring the power in order to ascertain the nature of the power and the limits within which it may be exercised.'

⁹⁵ *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821, 834.

⁹⁶ Section 171(b) CA 2006.

⁹⁷ See Nolan arguing that 'the proper purpose doctrine is better seen as supplementing the expressed intention of those who conferred discretionary power on the board' in RC Nolan, 'The Proper Purpose Doctrine and Company Directors' in BAK Rider (eds), *The Realm of Company Law* (Kluwer Law International, London, 1998) 19.

of company in different situations cannot be anticipated'.⁹⁸ Nevertheless, the logic of the theory of purposive constraints on delegated powers results in the provision of an opaque and unavoidably unhelpful power-specific rule of construction/ implied intention:

In their Lordships' opinion it is necessary to start with a consideration of the power whose exercise is in question, in this case a power to issue shares. Having ascertained, on a fair view, the nature of this power, and having defined as can best be done in light of modern conditions the, or some, limits within which it may be exercised, it is then necessary for the court . . . to examine the substantial purpose for which it was exercised.⁹⁹

The improper purpose doctrine should not be viewed as a rule of construction in relation to individual powers, designed to access the original or imputed delegated purposive intent of those powers. It is a doctrine that provides regulation of the balance of power between the board and the shareholder body. As Professor Davies notes, when Lord Wilberforce in *Howard Smith* comes to determine the legitimacy of the target board's action, the finding of illegality is not the result of specific analysis of the purposes for which the target's power to issue shares could be used but rather it is viewed as a function of the constitutional arrangements for the distribution of power between the board and the shareholder body.¹⁰⁰ Professor Sealy also argues that the improper purpose doctrine should be viewed in broad constitutional terms rather than through the lens of delegated powers; however, he submits that Lord Wilberforce's consideration of company constitutional arrangements was not part of the ratio of the case.¹⁰¹ With respect, Lord Wilberforce's constitutional observation is inseparable from the holding, whereas the rule of construction/ imputation disappears when the facts of the case are engaged:

the constitution of a limited company normally provides for directors, with powers of management, and shareholders, with defined voting powers having power to appoint the directors, and to take, in general meeting, by majority vote, decisions on matters not reserved for management. Just as it is established that directors, within their management powers, may take decisions against the wishes of the majority of shareholders, and indeed that the majority of shareholders cannot control them in the exercise of their powers while they remain in office (*Automatic Self Cleansing Filter Syndicate Co Ltd. v Cunningham*), so it must be *unconstitutional* for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist' (emphasis added).¹⁰²

⁹⁸ [1974] AC 821, 835.

⁹⁹ *ibid* 835.

¹⁰⁰ P Davies in *Gower and Davies's Principles of Modern Company Law* (7th edn, Sweet & Maxwell, London, 2003) 386.

¹⁰¹ Sealy (n 92) 305.

¹⁰² [1974] AC 821, 837.

Nor does pre-*Howard Smith* case law view the scope of the doctrine in terms of the delegated purposes of specific powers, rather the doctrine is viewed in broader constitutional terms. In *Hogg v Cramphorn*, Buckley J held that the courts will not 'permit directors to exercise powers, which have been delegated to them by the company in circumstances which put the directors in a fiduciary position when exercising those powers, in such a way as to interfere with the exercise by the majority of its constitutional rights'.¹⁰³

In application, therefore, the improper purpose doctrine is not a power-specific rule of construction; rather, it provides a constitutional rule of construction to determine the extent to which corporate action taken by the board alone may interfere with fundamental shareholder rights—the shareholder franchise and the right to alienate one's shares.¹⁰⁴ The doctrine provides a default balance of power settlement between the board and shareholder body. The shareholder body may alter this settlement to the extent of the available flexibility provided by the statutory regime. In the quote set forth above, whilst Lord Wilberforce holds that it 'must be unconstitutional', which sounds mandatory, this discussion is the product of what the 'constitution of a limited company normally provides' (emphasis added). Also, whilst Lord Wilberforce indicates that the powers of the board are fixed through his reference to *Automatic Self-Cleansing*,¹⁰⁵ it is clear that *Automatic Self-Cleansing* and similar cases involve the interpretation of the article delegating management power to the company. It is equally clear that it is open to the shareholder body to draft such an article in a way that reserves many powers, including directing management action, to the shareholder body.¹⁰⁶ Accordingly, to the extent that a corporate constitution provides for a different balance of power by containing tailored takeover defences or more broadly authorizing a company to develop and deploy takeover defences pre- or post-bid in order to deter, delay or frustrate a bid, the improper purpose doctrine is less likely to invalidate the use of corporate powers as defensive tools.

It is with regard to the default nature of the improper purpose doctrine that understanding the doctrine in constitutional rather than individual power terms becomes important. When viewed in constitutional terms the strict default position of the improper purpose doctrine may be dislodged vis-à-vis the exercise of specific powers, for example, the power to issue shares, by a provision elsewhere in the articles or by shareholder action. So, for example, a provision in the articles or a shareholder resolution providing the company with authority to

¹⁰³ [1967] Ch 254, 268.

¹⁰⁴ See text to nn 108–23.

¹⁰⁵ *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 35.

¹⁰⁶ Farrar notes, eg, 'that is open to a company to adopt whatever form of management article it pleases'. See also Davies (n 5) 209 noting that 'this restriction on director's conduct could in theory be circumscribed by an appropriate change in the articles'. See also Nolan (n 97) arguing that the doctrine is a presumptive default rule.

allot warrants in order to put a poison pill in place alters the balance of board and shareholder power with regard to defensive action in relation to all powers even though specific powers themselves have not been amended to cover defensive action. When viewed as a power-specific rule of construction, in order to dislodge the default position the individual power in question would have to be modified to enable defensive action, which, as others have noted, is unlikely in relation to public companies.¹⁰⁷

2. *The default position*

In *Hogg v Cramphorn*,¹⁰⁸ the board of Cramphorn Ltd issued additional shares to an employee trust formed by the company. As the trustees of the trust were the managing director of the company, the company's auditor and a company employee, the share issue to the trust ensured that a likely bidder, if successful, would not be able to command a majority of voting power. The board also resolved to loan the employee trust the funds to make an offer at the same price offered by the bidder.¹⁰⁹ Buckley J struck down the share issue and the loan. In relation to the loan, he held that:

It was an integral part of a scheme for securing for the directors the support of a controlling body of votes. The loan was not made with the single-minded, or even the primary purpose, of benefiting the company otherwise than by securing that control of the directors or facilitating their securing that control.¹¹⁰

For Buckley J, corporate powers to issue shares and to make loans could not be used for the purpose of securing the directors' control of the company. The objective of securing the directors' control, however, can cover a wide range of good and bad faith reasons for securing such control. In *Hogg v Cramphorn*, the court held that the directors were acting in good faith and with 'honourable intentions'. The board claimed that the corporate actions were motivated by the fact that the offer was inadequate and liable to 'unsettle' the company's employees upon whom the company was 'very dependent for its success and development'.¹¹¹ Buckley J's judgment makes it clear that these reasons are insufficient to justify such defensive corporate action. However, his judgment goes further. He suggests that there could not be *any* reason or justification for such action. Any belief about why such action would protect and benefit the company is 'even if well founded . . . irrelevant'.¹¹²

In *Howard Smith v Ampol Petroleum Ltd*, the board of the target company, RW Miller (Holdings) Ltd, when faced with an offer for its outstanding shares

¹⁰⁷ Davies (n 5).

¹⁰⁸ [1967] Ch 254.

¹⁰⁹ At the time the defences were put in place the bid had not formally been made, although the bidder had indicated the intended price.

¹¹⁰ [1967] Ch 254, 270.

¹¹¹ *ibid* 259.

¹¹² *ibid* 268.

from Ampol Petroleum Ltd, who together with Bulkships Ltd owned 55 per cent of the shares, issued additional shares to Howard Smith Ltd. Although the board claimed that the purpose of the share issue was to raise finance, the court found that the shares had been issued to enable a bid for the company by Howard Smith by reducing the percentage shareholding held by Ampol and Bulkships to a minority holding. Howard Smith was prepared to make an offer which exceeded the Ampol offer by 10 per cent. The Privy Council held that 'the issue of shares *purely for the purpose* of creating voting power has repeatedly been condemned' and that it is 'unconstitutional for directors to use their fiduciary powers over the shares in the company *purely for the purpose* of destroying an existing majority, or creating a new majority which did not previously exist'¹¹³ (emphasis added).

Lord Wilberforce's focus on purpose suggests a distinction, later deployed by their Lordships in the context of financial assistance,¹¹⁴ between purpose and reason. If the primary objective is to alter the balance of voting power by converting a majority into a minority then it does not matter why you are doing this: reason is irrelevant. This contrasts with dicta from the Canadian decision of *Teck Corporation Limited v Miller*,¹¹⁵ a decision that rejected the approach taken in *Hogg v Cramphorn*.¹¹⁶ In *Teck*, the board of Afton Mines Ltd entered into a contract with a third party to develop a copper mine. This type of contract was known in the industry as 'the ultimate deal' and typically involved a substantial issue of shares to the counterparty. However, the effect of this issue was to foreclose a bid for the company from Teck Corp. Berger J held that:

My own view is that directors ought to be allowed to consider who is seeking control and why. If they believe that there will be *substantial damage* to the company if it is taken over, then the exercise of powers to defeat those *seeking* a majority will not necessarily be improper (emphasis added).¹¹⁷

Interestingly, in *Howard Smith* Lord Wilberforce distinguishes *Teck* in a way that suggests some degree of approval.¹¹⁸ This does not, however, suggest that there is room in *Howard Smith* for a reason-based analysis of defensive action. Lord Wilberforce viewed *Teck* through a non-defensive lens: the company was attempting to strike the best deal for the company; given industry 'ultimate deal' practice this inevitably involved defeat for Teck if another party was selected.

More recent cases, however, have provided support for a more flexible reason-based analysis. *Cayne v Global Natural Resources PLC*¹¹⁹ involved the application of the improper purpose doctrine to the legality of a merger involving a UK PLC's US subsidiary. One of the terms of the merger included

¹¹³ [1974] AC 821, 837.

¹¹⁵ [1973] DLR (3d) 288.

¹¹⁷ *ibid* para 109.

¹¹⁹ (1982) Unreported LEXIS.

¹¹⁴ *Brady v Brady* [1989] AC 755.

¹¹⁶ *ibid* para 110.

¹¹⁸ [1974] AC 821, 837–8.

an issue of shares by the UK company, Global Natural Resources PLC. At the time of the merger a dissident group of shareholders had launched a proxy contest to remove the board of directors. In considering the improper purpose doctrine, Sir Robert Megarry VC noted that the principle set forth in *Hogg v Cramphorn* ‘must not be carried too far’. In considering whether a hypothetical company B could issue shares to a third party to ensure that a competitor and shareholder of company B could not use its shareholding to the detriment of company B, he noted that he saw no reason why the issue of shares ‘should not be a perfectly proper exercise of the fiduciary powers of the directors of company B. The object is not to retain control as such, but to prevent company B from being reduced to impotence and beggary’. Sir Robert Megarry VC, echoing Berger J’s dicta on ‘substantial damage’ in *Teck*, recognizes that behind the mantle of retaining control are legitimate and illegitimate reasons. He argues that there are defensive reasons that would justify action that *purposely* alters voting control. Importantly, the threshold for such justifications seems to be set very high: Megarry VC refers to avoidance of ‘impotence and beggary’. It is unclear whether this would include only extreme predatory minority shareholder behaviour or would it also, for example, apply to the break-up of hostile bids which would result in the post-completion sell-off of significant company assets? *Cayne* provides limited guidance on the set of legitimate reasons, but it does suggest that there are unlikely to be many.

It is also worth noting that the example given by Megarry VC involved the issue of shares to alter voting power but did not involve the conversion of a majority voting interest into a minority voting interest. Here we see that there is a possible regulatory relationship between legitimate reasons for (or ends of) the action and the means used to achieve those ends. Put alternatively, there may be more flexibility on reason for action where the infringement on the shareholder franchise is smaller. This would suggest that the defences and reasons to deploy defences that do not directly interfere with the franchise may be viewed more favourably by UK courts. However, *Hogg v Cramphorn* and *Howard Smith* would not support this position. In *Hogg v Cramphorn* the bidder had not acquired a majority position when the board acted and the court also invalidated the loan to an employee trust on the basis that it was a defensive measure to retain control. Lord Wilberforce in *Howard Smith* suggests that action intended to inhibit the ability to tender into an offer would be invalid: ‘the right to dispose of shares at a given price is essentially an individual right to be exercised on individual decision and on which a majority . . . is entitled to prevail’.¹²⁰

Accordingly, the scope for defensive action to be compliant with the *default* position provided by the improper purpose doctrine is unclear but unlikely to be significant. In the recent case of *Criterion Properties Plc v Stratford Properties LLC*,¹²¹ the Court of Appeal considered a case involving

¹²⁰ [1974] AC 821, 837–8.

¹²¹ [2003] 1 WLR 2108.

a takeover defence that did not interfere with the shareholder franchise. The defence involved a put option in a joint venture agreement that would have forced the target company to buy out a joint venture partner at an unfavourable price. In this case the Court of Appeal refused to consider the general question of whether defending against a predator could be a proper purpose. At best one could say that the court clearly did not feel that this was an area on which English law provided a clear position. In the space generated by uncertainty, in the absence of Rule 21, one would expect to see takeover defences deployed by companies and tested in the courts. However, as noted above, if English courts adopted, against the weight of authority, the position in *Cayne* it is still unlikely that companies would find many legitimate reasons for defensive action.

As the improper purpose doctrine's restrictions only relate to actions whose primary purpose is control-related, the absence of Rule 21 would encourage companies to search for defences that have a defensive impact but which can be characterized as non-defensive business decisions. This would exclude pure defences, such as poison pill arrangements, but could cover available asset-sale and recapitalization defences if it can be demonstrated that the primary motivation was not a defensive one. As other commentators have noted, however, where such actions are taken in a post-bid setting without a credible record that the actions were contemplated prior to the bid, it may be very difficult for the board to convince a court that the primary purpose was not a defensive one.¹²² Furthermore, the easier availability of a derivative suit for breach of duty introduced by the Companies Act 2006¹²³ is likely to make most boards wary of taking such action without strong evidentiary support for the claim that the action was not defensively motivated.

C. Defence Potency in Practice

Thus far the article has considered the formal availability of takeover defences and the ability of the board to deploy them in compliance with applicable directors' duties. Whilst it has been established that several defences would be unavailable, it is clear that in the absence of Rule 21 shareholders could provide the board with pre-bid formal authority to deploy certain tailored defences, such as poison pills, or to use certain corporate powers, for example, the power to sell assets, for defensive effect. Depending on the court's assessment of the balance of power between the board and the shareholder body in light of the defensive authority given to the board, the exercise of such powers could be compliant with the directors' duties. However, although formally available and duty compliant, defences will only be used to the extent that they are practically effective. If they do not in practice provide management with a credible threat to prevent or delay a bid, their entrenchment effect will be minimal, their usefulness in controlling the sale process and their relevance as

¹²² Davies (n 5).

¹²³ Part 11 CA 2006.

a bargaining chip to extract a higher premium will be limited, and they will not be used. This section considers in what ways, and to what extent, available defences would be practically effective.

1. Poison pills

In the United States the most effective and readily available takeover defence is the poison pill. The pill in theory allows the board to just say no, preventing the bidder from ever exceeding the ownership trigger threshold. The pill's defensive capability pivots on the refusal of the board to grant board approval for the tender offer and to redeem the pill. Accordingly, if the board can be replaced with bidder-friendly directors, then the pill could be redeemed and the bid could proceed. Thus, the logical step for any hostile bidder would be to commence a proxy contest at the same time as the offer was launched. Although there are additional transaction costs associated with a proxy contest, depending on deal size, these are normally not material. A proxy contest involves the holding of a shareholder meeting where the removal of the directors and appointment of new directors is proposed. Management and the bidder compete to obtain proxies from existing shareholders to win the shareholder vote. This shifts the regulatory focus away from the creative and complex arrangements which make up the form and operation of the poison pill onto the preconditions to a credible threat to replace the board.

There are several preconditions to a successful proxy contest and to the ability credibly to threaten to bring such a contest. First, it must be possible to remove a majority of the directors from the board. Ideally this can be done by removing the directors during the course of their term. To do this it must be possible under the applicable law to remove a director without cause, that is, without any evidence of malfeasance.¹²⁴ In addition, unless the bid is launched shortly before the annual general meeting, the shareholders must be able to act by consent, that is without a shareholder meeting, or it must be possible to call an extraordinary general meeting in which the shareholders will vote on the removal and appointment resolutions. If shareholders are empowered to call an interim shareholder meeting and remove the board without cause the potency of a pill is reduced to the time it takes successfully to complete a proxy contest and the transaction costs associated with that contest.

US corporate law is state-based law and so the nature of these basic-rule sets varies from state to state. Delaware General Corporation Law, for example, provides that these basic rules addressing director removal, term of office, the holding of shareholder meetings and control of the agenda are default

¹²⁴ *Ralph Campbell v Loew's Incorporated* 134 A.2d 852 (Delaware, 1957) referring to with cause removal as involving 'the worst sort of violation of his duty' (at 857) and charges of 'grave impropriety' (at 859).

rules. The default position is that directors are elected annually and may be removed without cause.¹²⁵ The company may, however, elect to have a staggered board, whereby the directors have three-year terms and one third of the directors' terms expire each year. Where a company adopts a staggered board, unless the certificate of incorporation provides otherwise, directors may only be removed with cause.¹²⁶ The certificate of incorporation or by-laws may, but need not, provide that the shareholders may call a special meeting (extraordinary general meeting)¹²⁷ although if the certificate contains a prohibition on shareholders calling special meetings this cannot be amended by the by-laws.¹²⁸

Accordingly, Delaware law enables a target, in theory, to disable any credible proxy contest threat. If a Delaware corporation has a staggered board this means that, against a determined incumbent board, the target would only be able to obtain control of the target board following two AGMs. Even if the bid is launched slightly before the first of these AGMs, the bidder will still have to wait for at least a year to obtain control of the company. If a company does not have a staggered board but does not allow shareholders to call interim meetings then, depending on the timing of the bid, the bidder may have to wait up to a year to launch a proxy contest.

One option which might occur to creative legal advisers would be to amend the constitutional documents at the annual general meeting to provide for without-cause removal, thereby effectively undermining the staggered board. If the provision providing for the staggered board is set forth in the company's by-laws, this would be possible. However, if the staggered board provision is set forth in the certificate of incorporation, as it should be in any well-advised corporation, then this would not be possible as under Delaware corporate law the certificate of incorporation can only be amended with the approval of *both* the board and the shareholders.¹²⁹

The consensus position in the United States' corporate academy is that alone the poison pill is not an effective takeover defence which enables a target to repel or 'just say no' to a bidder. Its potency is dependent on the fact that board removal and shareholder meeting regulation is default regulation that can be moulded together with an existing or latent¹³⁰ poison pill to create significant defensive capability. For scholars who are concerned that Delaware takeover law enables management to entrench themselves, their focus of concern is not on the poison pill but on the default background rule set. Professor Subramanian puts it as follows:

¹²⁵ Section 141(k) DGCL.

¹²⁶ Section 141(d) and 141(k) DGCL.

¹²⁷ Section 211(d) DGCL.

¹²⁸ The by-laws cannot be inconsistent with the certificate of incorporation (s 109 DGCL). By-laws can be amended unilaterally by the board or the shareholders.

¹²⁹ Section 242(b) DGCL.

¹³⁰ A poison pill can be put in place by the target after the bid has commenced (*Unitrin v American General Corp* 651 A.2d 1361 (Delaware, 1995)).

No academic commentator today (including myself) questions the . . . right of a target board to maintain a pill for a limited period of time, in order to identify a higher value buyer or to inform shareholders about the bid.¹³¹

For these scholars, provided that the board does not have the ability to maintain defences for an unlimited period of time,¹³² then the pill should be available to provide management with sufficient time to find a better value third party or a better value restructured bid and to enable an undistorted shareholder vote¹³³ on the offer.

Even where the board is not protected by a staggered board or shareholder meeting provisions, removing the board is a significant step for shareholders to take especially when the bid will not be commenced prior to the shareholder vote or, where the bid is commenced contemporaneously, the bid is subject to additional conditionality, for example, a material adverse change clause or an acquisition threshold of greater than 50 per cent. Shareholders may be satisfied with existing management's performance and may be concerned that should the bid fail they will be left with management who have a close relationship with one minority shareholder group, and are unknown and possibly weaker than existing management. Shareholders with these concerns may prefer that the board redeems the pill to allow the offer to proceed but remain unwilling to remove the board. Such concerns increase the credibility of the poison pill threat even without board removal protections.

An alternative and less drastic shareholder response to the board's refusal to redeem the pill would be for the shareholder body to instruct the board to redeem the pill through a by-law amendment. In most US jurisdictions, and the presumptive position in Delaware,¹³⁴ unless the certificate of incorpora-

¹³¹ G Subramanian, 'Bargaining in the Shadow of Takeover Defenses' (2003) 113 *Yale Law Journal* 621, 654.

¹³² Bebchuk, Coates and Subramanian recommend that courts should not allow management protected by a staggered board to block a takeover bid if they lose one election. This would give the board up to approximately a year, depending on when the bidder makes his intentions clear (L Bebchuk, J Coates IV, and G Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy' (2002) 54 *Stanford Law Review* 887, 944.

¹³³ Proponents of the undistorted shareholder vote idea argue that by forcing a proxy contest the shareholders have an opportunity to vote on the control transaction separately from tendering their shares. This is considered important for two reasons: first, because even though you do not wish to tender if you expect other shareholders to tender then you will tender because you will not want to remain as a minority shareholder in a company with a substantial majority shareholder who may act to the detriment of minority shareholders in ways that are unactionable; second, if most shareholders tender the likely consequence is that the shareholder will be squeezed out in any event for equivalent consideration, in which case the refusal to tender has simply cost the shareholder the time value of money for the period from completion to squeeze out which in the US could take up to three months. A separate vote on the deal through a proxy contest is not, however, subject to these tender pressures (see Bebchuk (n 13)).

¹³⁴ CF Richards and RJ Stearn, 'Shareholder By-Laws Requiring Boards of Directors to Dismantle Rights Plans are Unlikely to Survive Scrutiny Under Delaware Law' (1999) 54 *Business Lawyer* 607. In Oklahoma such resolutions have been held to be binding see *International Brotherhood of Teamsters General Fund v Fleming Cos* No CIV-96-1650-A (WD Oklahoma, 1997).

tion provides otherwise such resolutions are not binding but are only precautionary. Any attempt to amend the certificate of incorporation to provide otherwise comes up against the dual board and shareholder approval requirement for certificate amendment.

The basic rule flexibility upon which the defensive potency of US poison pills rests is not available in the UK. Accordingly, even if, in the hypothetical absence of Rule 21, the poison pill defence is formally available, it makes little practical sense to attempt to deploy one. The reason for this is that there is limited scope for the board of directors of a UK company to protect themselves from removal or to delay any attempt to remove them. It is a mandatory rule of UK company law that all directors regardless of their term in office can be removed by a majority of the votes cast at the meeting.¹³⁵ No reason or cause has to be established to remove a director. It is also a mandatory rule that the directors of a company shall convene an extraordinary general meeting within 21 days of the receipt of a requisition to do so by members representing at least one-tenth of the paid-up voting share capital of the company.¹³⁶ If the board does not do so the members who made the requisition may call a meeting themselves and have their reasonable expenses reimbursed by the company.¹³⁷ Accordingly, UK company law always enables shareholders to meet outside of the AGM. If the meeting is brought to remove a director then special notice is required, which means the company must receive notice of the intention to remove the director 28 days before the meeting at which such a resolution will be moved and the shareholders must receive notice of the resolution at least 21 days before the meeting.¹³⁸ Accordingly, where the board refuses to call a requisitioned meeting an efficient hostile bidder can remove a resistant board within 42 days.¹³⁹ The board, however, could slightly prolong this period by actually calling the meeting in accordance with the Act on the 21st day following the requisition for a date 28 days after the date of the notice convening the meeting.¹⁴⁰ This would extend the removal period to 49 days. If the proxy context is commenced at the same time as the takeover offer subject to pill redemption conditionality then the offer will only be 28 days longer than the shortest time frame within which an offer could be completed and in fact will be similar in length to the time period it takes to complete many takeovers.¹⁴¹

¹³⁵ Section 303 CA (s 168 CA 2006).

¹³⁶ Section 368(2) CA (s 303(2) CA 2006).

¹³⁷ Section 368(4) and (6) CA (s 305 CA 2006).

¹³⁸ Section 379 CA 1985 (s 312 CA 2006—note that s 312 reduces the shareholder notice period to 14 days).

¹³⁹ 21 days from T1 (date of requisition) waiting for the directors to call the requisitioned meeting plus 21 days notice to the general meeting under the special notice requirements. The 28-day special notice period to the company is satisfied if given at T1. Please note that the removal period will be reduced to 35 days when the 2006 Act comes in to force as the shareholder notice period for director removal is reduced from 21 to 14 days.

¹⁴⁰ Section 368(8) of the 1985 Act and section 304(1)(b) of the 2006 Act require that the meeting be called for a date not later than 28 days after the date of the notice of the meeting.

¹⁴¹ Rule 30.1 Takeover Code (2006) requires that the offer document should normally be posted

If concern about removal of the board and subsequent bid failure undermined the likely success of the proxy contest, under UK company law the shareholder body could simply instruct the board to redeem the pill. Currently the default position under Article 70 of Table A provides that the powers of the board to manage the company are subject to any direction given by special resolution: 75 per cent of the shareholders voting at a general meeting. That is, in contrast to most US state corporate law, shareholder directions are binding not precatory. To the extent that such an option is foreclosed by tailored articles, direction can be given by the same proportion of votes by an amendment to the articles by special resolution. For such resolutions 21 days' notice is required, which means that the minimum time period required to force a redemption of the pill would be 42 days¹⁴² if the board failed to call a requisitioned meeting and 49 days if they called a requisitioned meeting for a date 28 days after the date on which the meeting is convened.¹⁴³ Accordingly, in the UK in the absence of Rule 21 it would make no practical sense to develop and deploy a poison pill.

2. Business combination defences

Business combination defences usually contain a board approval mechanism that triggers the defence only in relation to bidders that cross the specified ownership threshold without approval. This way the defence is only deployed against unwelcome suitors. The act of refusing to approve a bidder would amount to frustrating action prohibited by Rule 21. However, as with the poison pill, even in the absence of Rule 21, this defence would be wholly ineffective in the UK due to the basic background rule set that allows the shareholders to remove the board or instruct the board to resolve that the bidder is an approved bidder.

3. Restructuring and asset sale defences

As we have seen, in the absence of Rule 21, the scope for a board of a UK company to craft a restructuring or asset sale defence is restricted. Assuming

within 28 days of the announcement of a firm intention to make an offer. Rule 31.1 requires that an offer must be open 'for at least 21 days following the date on which the offer document is posted'.

¹⁴² The 2006 Act reduces the notice period for meetings at which special resolutions are moved to 14 days, which would reduce the minimum time period to force a redemption to 35 days. See ss 283 and 307 CA 2006.

¹⁴³ As under the UK Takeover Code, any successful bidder is required to offer an extended offer period of 14 days for those shareholders or refuse to tender initially (Rule 31.4 Takeover Code (2006)), there is no distortion in the tendering process (see n 133) which a proxy contest vote or pill redemption resolution would remedy. Any shareholder who does not tender in the initial offer has no concern about being left behind as a minority shareholder if the bid is successful nor any significant concern about lost value as a result of later payment; he simply accepts the offer after the initial successful offer closes.

that board action is compliant with the proper purpose doctrine, the board could increase leverage and issue an interim dividend provided that there are sufficient distributable profits, or sell assets of up to 25 per cent of company value. It could not, without contemporaneous shareholder approval, issue a substantial block of shares to a friendly third party,¹⁴⁴ commence a share buy-back or sell assets worth more than 25 per cent of company value. This does, however, leave significant scope for defensive action. If the bidder is a highly leveraged bidder, as is typical with a private equity bidder, increasing leverage and issuing an interim dividend could render the bid infeasible. Asset sales of 25 per cent or less of the value of the company or the threat to negotiate such sales could be a particularly effective defence against a break-up bid that is premised on the idea that the company is worth less than the sum of its parts. In such a case the defensive threat is simply to put the break-up process into operation pre-bid in order to realize higher value for the shareholders. The asset-sale threat is also available in the context of a bid that is not intending to break up the company post-completion. The credibility of such a threat may, depending on the circumstances, be constrained by the interdependence of the assets whereby the sale of the prized asset would destroy value in the rest of the company's business.

These defences could be used to offer the shareholder body an alternative to the bid, as a bargaining chip with the bidder, or as a mechanism for obtaining more time to control the sale process. They could also be used by management to protect their jobs in the face of an excellent value offer. However, there is good reason to doubt that in practice the available entrenchment effect of these defences is significant in the UK. It is certainly less than it would be in the United States. Management of a US company protected by a compliant and staggered board¹⁴⁵ can incur the wrath of shareholders by repelling a bid and face no serious threat of subsequent removal in the short to medium term. This is not the result of the collective action problem but rather a result of the fact that it will take two proxy contests and over a year at least to obtain control of the board—time in which shareholders' fury and focus is likely to wane. In the UK a board that hypothetically deploys or threatens to deploy the asset-sale defence to repel a premium bid has no such post-bid protection. The board could, in theory, be removed within 49 days. The collective action problem provides a protective cushion for management, but the more self-interested the action appears the greater the likelihood that in collective outrage it may be overcome.¹⁴⁶ Furthermore, this different background rule set enhances

¹⁴⁴ Although formally it is possible that the shareholders could provide a pre-bid rolling large pre-emption waiver, in practice, we see that the pre-emption guidelines mean that such waivers are for low single digit percentages of outstanding shares. See text to nn 52–5.

¹⁴⁵ As of 1998 60 per cent of US publicly traded companies had staggered boards (Investor Responsibility Research Center, *Corporate Takeover Defenses* (1998)).

¹⁴⁶ See, eg, the proxy contest to remove the entire board of Tace PLC in 1992 organized by Norwich Union. See generally, Black and Coffee (n 41) 2042–6.

the bargaining position of investors when they attempt to exert pressure for change. In the UK such investors have an immediate and plausible big gun¹⁴⁷ to back up their demands.¹⁴⁸ In the United States, where a company's board is effectively staggered, pressure is not backed up by the realistic possibility of sanction. In the post-Enron environment UK institutional investors have demonstrated their increasing willingness to exert pressure when dissatisfied with board behaviour over appointments,¹⁴⁹ remuneration¹⁵⁰ or strategy.¹⁵¹ Although it remains clear that the costs of activism prevent hands-on operational monitoring by institutional investors, these investors are willing to act in relation to high profile discrete issues that are framed in terms of poor governance or managerial self-interest. Using defences without a strong business case which the shareholder body would view as legitimate would quickly be framed in terms of entrenchment which could ignite institutional investor activity. Furthermore, if defensive activity risks being framed in entrenchment terms it necessarily risks damage to the manager's reputation. Should she be removed, her value in the job market will be much diminished. It would, therefore, be irrational for management to abuse their corporate power for incumbency purposes if the act of abuse both substantially increases the likelihood of their removal and damages their reputation in the job market. In practice, therefore, the entrenchment effect of the asset sale defence or the leveraged interim dividend are significantly curbed by the UK's basic company law rules, the potential for institutional investor activism, and the market in managerial reputation.

III. JUSTIFYING LIMITS ON CONTRACTUAL FREEDOM

Section II demonstrates that if we posit the abolition of Rule 21 then, subject

¹⁴⁷ Paul Davies notes that the power to remove the board under UK law is the basis for the view of Bob Monks (vice-chairman of Hermes Lens asset management) that the UK is "easily the world leader" in the accountability of managers to investors' (P Davies, 'Shareholder Value: A New Standard for Company Conduct? A (British) Common Law View' (working paper on file with the author)).

¹⁴⁸ For examples of where the threat of proxy contest resulted in board capitulation see the removal of the CEO of Coffee Republic following a meeting called by shareholders to remove the CEO (see 'Shareholders Oust Coffee Republic Founder' *Financial Times* (London, 21 Oct 2006) 18). See also, the removal of the CEO of Brown and Jackson Plc and the replacement of the CEO and a majority of the board in Spring Ram Plc (see Black and Coffee (n 41)).

¹⁴⁹ See, eg, the proposed appointment and withdrawal within a week of Sir Ian Prosser as Chairman of Sainsbury Plc (see: 'Investor Fury at Sainsbury Rejig' *Financial Times* (London, 11 Feb 2004)).

¹⁵⁰ See investor 'anger' in relation to the approval of Sainsbury's 2003 remuneration report ('Sainsbury's board set for lifeline: family to back controversial remuneration report' *Financial Times* (London, 12 July 2004)) and investor's responses to Vodafone bonuses in 2006 ('Vodafone investors prepare for battle over bonus plans' *Financial Times* (London, 19 Apr 2006)).

¹⁵¹ See 'Investors unite to confront Vodafone' *Financial Times* (London, 10 June 2006); 'Vodafone under pressure on strategy amid huge write-down' *Financial Times* (London, 29 May 2006).

to leveraged interim dividends and less-than-25 per cent asset sales, there would still be no *post-bid* ETDs available to the board of a UK target without contemporaneous shareholder approval. Importantly, the dividend and asset-sale exceptions are only available where prior to the bid the company's constitution alters the default balance of power provided by the improper purpose doctrine either explicitly by providing that corporate powers can be used for defensive purposes or implicitly by providing for a tailored takeover defence, such as a poison pill.¹⁵² Accordingly, the only post-bid director-controlled ETDs that are blocked by Rule 21 alone are defences that a pre-bid shareholder body would have elected to put in place. Recent US evidence that the large majority of companies going public have potent complementary defences suggests that, given the option, sophisticated UK shareholders, such as private equity investors, who control a company prior to its initial public offering (IPO), would elect to make such ETDs available to the board. Whilst in the US institutional investors are vocal and active in their opposition to the mid-stream adoption of takeover defences through charter amendment and the adoption of poison pills without shareholder approval,¹⁵³ they are involved in both the buy and sell side¹⁵⁴ of IPOs by companies with constitutions which provide for staggered boards and prevent shareholders from calling a special meeting or acting by consent. Of the 6000 US companies going public between 1987 and 1999, 50 per cent had staggered boards. However, of those going public in 1999, 82 per cent had staggered boards.¹⁵⁵ In 1998 51.2 per cent of companies going public prevented shareholders from calling interim meetings.¹⁵⁶

Much hand-wringing has taken place in US corporate academic circles trying to explain this phenomenon.¹⁵⁷ Is this evidence that potent defences are value-maximizing or is the price of the shares subject to a discount to take

¹⁵² Although, as demonstrated above poison pills are in themselves practically ineffective they indicate an intention to alter the balance of power between the shareholders and the board.

¹⁵³ Klausner summarizes research by the Investor Responsibility Research Center (Investor Responsibility Research Center, *Voting by Institutional Investors on Corporate Governance Issues* 5 (2001)) regarding US institutional investor voting practices as follows: '59% [of the survey respondents] consistently vote against management proposals to adopt classified [staggered] boards, and 65% vote in favor of shareholder proposals to repeal classified boards. Institutions oppose management control over poison pills as well, with 72% of survey respondents voting in favor of shareholder proposals that ask management to submit pills to shareholder vote before adoption' M Klausner, 'Institutional Investors, Private Equity and Anti-takeover Protection at the IPO Stage' (2003) 152 *University of Pennsylvania Law Review* 755, 760. He also notes that the institutional investor opposition to the mid-stream adoption of staggered boards has meant that management realizes that 'there is no point in even asking shareholders to support a [staggered] board' (758).

¹⁵⁴ eg through their investments in private equity limited partnerships.

¹⁵⁵ Klausner (n 153) 763–4.

¹⁵⁶ Note, however, that the prohibition on calling an interim meeting is defensively less important when directors can only be removed with cause, which is normally the case when the company has a staggered board.

¹⁵⁷ See Klausner (n 153) 766–84.

account of the negative value effects of these defences?¹⁵⁸ What is clear, however, is that providing companies with defences is the preference of sophisticated shareholders that retain a significant stake in the company. Whilst non-shareholder value explanations of this have been proffered¹⁵⁹ one cannot discount the possibility that in some cases owners want to protect the company from takeover to ensure that their remaining stake in the company is not cashed out by a future bidder who offers a premium that does not reflect the company's long-term value. Whether or not as an empirical matter this turns out to be the case is irrelevant to the shareholders' view and preference at the time of the IPO. Any prohibition of shareholders' contractual expression of such preferences requires a persuasive rationale.¹⁶⁰ This section evaluates the available rationales.

A. Post-bid Votes and Shareholder Sovereignty

Proponents of the non-frustration principle could argue that it does not foreclose using an available defence as any such defence can be implemented with post-bid shareholder approval. This is unpersuasive. Requiring post-bid rather than pre-bid approval can alter the effectiveness of the defence. With an asset-sale defence, for example, in order for the defence to be credible the target must be able to negotiate a sale with a third party interested in those assets. Carrying out legal and financial due diligence on the assets as well as negotiating their sale can be very costly. There are also reputation costs for a third-party purchaser who fails to complete the purchase. Any third party approached to consider the purchase of such assets will be wary of incurring those costs when the target may well be using the third party simply to extract a higher premium from the bidder. Concern about the costs of an unsuccessful transaction will be heightened if a shareholder vote could veto the sale. A potential third-party purchaser will be aware that even if the asset sale offers better value for the particular asset, shareholders may still prefer to exit their entire investment. Post-bid shareholder approval for an asset sale may well, therefore, undermine the asset-sale defence. Accordingly, a post-bid shareholder approval process does not provide a rationale for removing pre-bid approval of a director-controlled post-bid asset-sale defence.

Proponents of the non-frustration principle view the principle as the logical outcome of a commitment to shareholder sovereignty: shareholders decide whether to sell their shares or whether or not to approve proposed defensive

¹⁵⁸ *Debevoise & Plimpton's Private Equity Report* (2003) 3, notes that 'underwriters have frequently advised that including a normal set of shark repellants—including a poison pill—will not harm the marketability of the IPO shares'.

¹⁵⁹ See Klausner (n 153) 766–84.

¹⁶⁰ This rationale demand also applies to the mandatory background rule of UK company law analysed in this article, however, the focus of this article remains on Rule 21.

action.¹⁶¹ As the Winter Report puts it: 'shareholders should be able to decide for themselves'.¹⁶² This is misleading. Shareholders may rationally choose to constrain future shareholder rights by providing for a different balance of power between the board and the shareholders. Posit a small shareholder group who own and actively control a close company. The shareholders elect to take the company public and realize some of their capital gains but intend to maintain a substantial holding in the company and to continue to be operationally active. They are concerned that new shareholders, no matter how sophisticated, will not appreciate the long-term value of the company when faced with a well-timed premium offer and realize that if such future shareholders are inclined to accept an offer then they will not authorize post-bid defensive action. A rational shareholder group with this concern would provide the board with as much defensive capability as English law allows. If this choice is not available because it is blocked by the non-frustration principle, shareholder sovereignty is undermined. In contrast, the sovereignty of shareholders who purchase shares in a company where post-bid defensive action is authorized ex-ante is unaffected if their opportunity to accept or reject a bid is inhibited by board action; the price they paid took account of this risk.

B. The Collective Action Problem

A second rationale for foreclosing this defensive flexibility is a paternalistic one based around the potential for management to exploit the collective action problem. The argument is that if this option is made available then inactive shareholders who have poor financial incentives to pay attention to the company's activities, including amending its constitution, may well approve defensive flexibility without giving adequate consideration to its potential negative effects during a future takeover bid. This contrasts with an approval request during an actual bid, where an offer is likely to ignite shareholders' attention to the actual effects of a proposed defence. In the context of takeover defences this is a weak argument. Even though institutional shareholders may not have large enough holdings to be hands-on monitors of corporate action it is clear that in relation to what are regarded as key governance or value issues they actively mould corporate action.¹⁶³ The most obvious example of this behaviour in the UK is the Pre-emption Group that informally and effectively restricts pre-emption right waivers.¹⁶⁴ Evidence from the US also shows that

¹⁶¹ See references set forth in nn 6 and 7.

¹⁶² See (n 9).

¹⁶³ See text to nn 146–51.

¹⁶⁴ Generally on the Pre-emption Group see <<http://www.pre-emptiongroup.org.uk/>>. The Pre-emption Group's Principles provide for routine institutional investor support for the disapplication of pre-emption rights provided that the annual disapplication does not amount to more than 5 per cent of the ordinary share capital of the company or 7.5 per cent in a three-year rolling period.

once aware of the apparent negative implications of takeover defences institutional shareholders can act to inhibit them. Witness, for example, the inability of companies without staggered boards to try and obtain shareholder approval for an amendment to the constitution to introduce one. Institutional shareholder opposition has resulted in a sharp decline in the number of companies requesting such approval.¹⁶⁵ Given the widespread sense amongst UK investor circles that takeover defences are value-destructive, one would expect UK institutional shareholders to be similarly circumspect. Accordingly, even if available, defensive mid-stream constitutional amendments are not subject to a collective action problem.

There is, however, considerable scope for introducing such defences at the IPO stage. As noted above, recent US evidence shows that most companies going public contain ETDs including staggered boards. However, purchasing shares in companies containing these defences does not generate the same paternalistic fervour as mid-stream constitutional amendments. Shares are a package of rights set forth in the constitutional documents. If you do not like the rights you can elect not to buy or to buy at a discount to reflect what you consider to be the value-negative rights. However, you can have no complaint about buying the rights if, aware of the defences, you purchase without discount¹⁶⁶ or discount to take account of those rights. It could be the case that investors do not pay attention to or fail to take account of such rights: that is, in relation to certain provisions set forth in companies' constitutions the capital markets are inefficient.¹⁶⁷ But even if this is the case it is not clear why the law should paternalistically protect investors who are perfectly capable of reading about and understanding such rights at the time of purchase.

C. Agency and Incompetence Costs

A third justification for Rule 21 foreclosing the limited defensive flexibility left open by English company law focuses on the effect that takeover defences have on the operation of the market for corporate control, and the role of the market for corporate control in restraining agency costs and what I shall call incompetence costs.

Agency costs are the costs that shareholders bear as a result of the fact that managers' interests are not wholly aligned with shareholders' interests. Examples of these costs include, amongst others: the costs incurred as a result of action that benefits managers at the shareholders' expense, such as shirking, self-dealing and excessive perquisites; the costs of attempting to align managers' interests with those of shareholders through remuneration; and the costs incurred through monitoring to prevent self-interested behaviour.

¹⁶⁵ See n 153.

¹⁶⁶ See n 158.

¹⁶⁷ Considering such an a possibility see: R Daines and M Klausner, 'Do IPO Charters Maximze Firm Value? Antitakeover Defences in IPOs' (2002) 17 *Journal of Law, Economics and Organization* 83, 113; Klausner (n 153) 780–2, in particular, n 88.

Incompetence costs are the costs that shareholders bear as a result of poor management decisions untainted by self-interest. In theory the market for corporate control can check both types of costs. Managers who use corporate power to directly or indirectly benefit themselves or shirk and prioritize their personal life over their professional obligations lower the value of the company and its share price. This value delta represents an opportunity for potential bidders and a threat to incumbent management's employment. Incompetent management similarly lowers the value of the shares and represents an opportunity for potential bidders. A premium paid to shareholders may, amongst others, represent a portion of this value delta. The market for corporate control thereby both disincentivizes agency and incompetence costs and ensures that existing shareholders do not bear the full extent of these costs. According to this theory, the more active the market for corporate control the less scope for agency costs and the lower the likelihood that incompetent management survives. Anything that gets in the way of the market for corporate control activity, such as takeover defences, necessarily increases the scope for unsanctioned agency and incompetence costs.¹⁶⁸

In analysing this justification for the non-frustration principle we need to understand the extent to which there is an agency cost or an incompetence cost problem in the UK that is not controlled by other mechanisms; if these costs are already controlled then the market for corporate control will be less significant or even superfluous in this regard. Furthermore, we need to understand whether non-controlled agency or incompetence costs are likely to be of such magnitude that they trigger a market for corporate control activity: do the agency or incompetence cost savings of replacing management exceed the transaction costs of taking over the firm?

In the UK the case has not been made that agency costs require the market for corporate control to keep them in check. UK executive remuneration has increased markedly over recent years and is increasingly reliant on performance-based compensation.¹⁶⁹ This in itself may be indicative of self-interested executive action although their value itself is in most cases immaterial when compared to company value. As is well known, increasing performance-based compensation may, however, be a more cost-effective way of ensuring that corporate actions are not tainted with self-interest. The scope for management to act in their own interests apart from directly or indirectly increasing remuneration and perquisites is limited in the UK. A strict duty of loyalty creates limited scope for personal exploitation of opportunities that would be of interest to the company without shareholder approval.¹⁷⁰ Whilst the directors can

¹⁶⁸ See Easterbrook and Fischel (n 11).

¹⁶⁹ See MJ Conyon and GV Sadler, 'How Does US and UK CEO Pay Measure Up?' (2005), working paper on file with the author.

¹⁷⁰ *Bhullar v Bhullar* [2003] EWCA CIV 424. Section 175(5) of the Companies Act 2006 allows public companies to elect, through their constitutions, to empower the board to approve director exploitation of such opportunities.

enter into pre-disclosed self-dealing transactions with the company and keep the proceeds therefrom,¹⁷¹ if such transactions involve the sale or purchase of assets exceeding £100,000 in value they must be approved by the shareholder body.¹⁷²

In relation to incompetence costs, there are two roles which the market for corporate control could play: first, improving competence; and second, replacing failing management. Fear of losing one's job will not enable an individual to exceed his capability constraint. However, individuals may fail to make the most of their ability for reasons that do not fit within the label of shirking. Incentives matter for getting the most out of management. There is, however, no reason to think that the abstract possibility of a takeover bid is more likely to maximize (within an individual's capacity constraint) competence than the more immediate financial incentives of performance-related pay. With regard to replacing failing management, there is evidence that in the UK boards will act to replace failing management. This is particularly apparent in the most poorly managed companies.¹⁷³ The increasing independence of UK boards following recent amendments to the Combined Code should enhance such discipline.¹⁷⁴ However, if performance is not viewed as poor enough for the board to act or if the apparent independence of the board is subverted, there remains, in theory, an important role for the market for corporate control to play.

The moot question is whether existing agency and incompetence costs are significant enough to trigger takeover activity and, if they are, whether the control market in practice appears to be responsive to these costs. Recently Blanaid Clarke has argued that 'most instances of self-dealing will not result in a significant enough discount in the company's share price to justify the substantial takeover premium that normally prevails'.¹⁷⁵ This echoes earlier US work by John Coffee who concluded that 'the level of efficiency is either "not extreme enough to justify the necessary premium or so extreme as to surpass the offeror's level of risk aversion"'.¹⁷⁶ Empirical evidence in the UK is consistent with this position. Frank and Mayer's study of 80 hostile bids in the UK between 1985 and 1986 found that there was 'no evidence of either high bid premiums or poor pre-bid performance when takeovers involve managerial control changes'. They concluded that 'the market for corporate

¹⁷¹ Art 85 and 94 of Table A Arts (Companies (Tables A to F) Regulations 1985, 1985/805, Schedule, Table A (ss 177, 180 CA 2006)).

¹⁷² Section 320 CA 1985 (s 190 CA 2006).

¹⁷³ MJ Conyon and A Florou, 'Top Executive Dismissal, Ownership and Corporate Performance' (2002) London Business School Working Paper (available at SSRN <<http://ssrn.com/abstract=304940>>).

¹⁷⁴ Combined Code (Financial Reporting Council, 2006)

¹⁷⁵ B Clarke, 'Articles 9 and 11 of The Takeover Directive (2004/25) and the Market for Corporate Control' [June 2006] *Journal of Business Law* 355, 359.

¹⁷⁶ *ibid* 360 (J Coffee, 'Regulating the Market for Corporate Control: a Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 *Columbia Law Review* 1145, 1202-3).

control does not, therefore, function as a disciplinary device for poorly performing companies'.¹⁷⁷

D. Value Destruction

If takeover defences destroy shareholder value then they externalize a cost on the economy as a whole. Their prohibition is then viewed as a justifiable intervention into the freedom of contract in the interests of maximizing social welfare. On the other hand, if takeover defences make a positive contribution to shareholder value then one would have to look elsewhere to rationalize their prohibition. The US debate pivots around value: those opposed to defences seek to demonstrate negative value implications; those in favour search for indications of value creation. In assessing the value implications of defences commentators have focused on: the reaction of capital markets to the adoption of defences; the effect of defences on takeover activity; the return on capital for rejected bids compared to the market as a whole; the operational performance of companies with takeover defences; and the premiums received by shareholders in companies with and without defences. Recently, Blanaid Clarke in her review of the literature concludes that:

While the empirical evidence is often contradictory, the majority of evidence would appear to support the hypothesis that defensive actions reduce shareholder value and are best explained as a device for management entrenchment.¹⁷⁸

This article submits that the literature does not provide any such clarity regarding the relationship between value and takeover defences; there is no majority position. John Coates has clearly demonstrated that much of the empirical work on the value implications of takeover defences is deeply flawed.¹⁷⁹ In relation to event studies that attempt to isolate the value effects of poison pill adoption on a company's share price,¹⁸⁰ he concludes, among other things: that the studies are inconsistent from study to study and inconsistent over time; that they suffer from methodological problems in identifying the data set; that earlier studies' negative value findings may be a function of markets misestimating the implications of what was then an innovative defence; that the studies fail to take account of the fact that a pill can be adopted at any time, so that a company without a pill is no different defensively (ignoring the interaction with other defences) than a company with a pill; and that the studies fail to take account of how pills interact with other defences. In relation to event studies of takeover defences included in the company's constitution, he

¹⁷⁷ J Franks and C Mayer, 'Hostile Takeovers in the UK and the Correction of Managerial Failure' (1996) 40 *Journal of Financial Economics* 163, 180.

¹⁷⁸ Clarke (n 175) 362.

¹⁷⁹ JC Coates IV, 'The Contestability of Corporate Control: A Critique of the Scientific Evidence' (1999) Harvard John M Olin Center for Law, Economics and Business Discussion Paper No 265 (available at SSRN <<http://ssrn.com/abstract=173628>>).

¹⁸⁰ *ibid* 11–29.

concludes that the results are mixed and that insignificant results predominate. More fundamentally, he observes that studying the value implications of these defences makes little sense in an environment that permits poison pills that thereby render these other defences of little consequence. In relation to pill and charter amendment event studies he concludes that the problems he identifies 'reduce the value of prior event studies to the vicinity of zero'.¹⁸¹ The 'principle mystery about event studies of takeover defences' he submits, is 'how researchers managed to find any results, or why anyone took those results seriously'.¹⁸² In relation to studies of takeover premiums, he notes that the studies looking at the relationship between pill adoption and takeover premiums consistently demonstrate that those companies with pills obtain higher premiums in subsequent bids. This is usually explained by the increased negotiating power that such defences give the board. However, he argues that there is no necessary causal connection between the pill and the increased premium. The reason for this is that, as noted above, as a company can adopt a pill at any time there is, in pill terms, no difference between a company with a pill and one without a pill. In relation to market for corporate control activity, Coates' review of the evidence concludes that pills alone do not deter bids. More recent work supports this assessment.¹⁸³

Some support for the position that defences destroy value is found in work looking at the effect of reorganization defences. Dann and DeAngelo in a survey of hostile takeovers from 1962 to 1983 found significant negative stock market returns at the time a defensive restructuring was announced.¹⁸⁴ One would not, however, wish to place excessive weight on these findings. The sample was small and the time period for analysing the returns does not extend beyond the announcement date. Whilst the authors conclude that their findings are consistent with the entrenchment hypothesis they acknowledge that it is not the only possible explanation.¹⁸⁵ Others have argued that companies that adopt defences have poorer operating performance.¹⁸⁶ More recently, a study by Danielson and Karpoff found that 'operating performance generally improves during the five-year period following pill adoption' which is 'inconsistent with the view that pills degrade performance'.¹⁸⁷

¹⁸¹ *ibid* 38.

¹⁸² *ibid* 69.

¹⁸³ RA Heron and E Lie, 'On the Use of Poison Pills and Defensive Payouts by Takeover Targets' (2006) 79 *Journal of Business* 1783.

¹⁸⁴ L Dann and H DeAngelo, 'Corporate Financial Policy and Corporate Control' (1988) 20 *Journal of Financial Economics* 87.

¹⁸⁵ *ibid* 114.

¹⁸⁶ GA Jarrell, JA Brickley, and JA Netter, 'The Market for Corporate Control: the Empirical Evidence Since 1980' (1988) 2 *Journal of Economic Perspectives* 49. PA Gompers, JL Ishii, and A Metrick, 'Corporate Governance and Equity Prices' (2001) NBER Working Paper No 8449.

¹⁸⁷ MG Danielson and JM Karpoff, 'Do pills poison operating performance' (2006) 12 *Journal of Corporate Finance* 536, 552.

Subsequent work by Coates together with Bebchuk and Subramanian has looked at whether pills in combination with an effective staggered board (ESB)¹⁸⁸ can effectively repel takeover bids and what impact resistance has on shareholder value.¹⁸⁹ They conclude that the ESB–pill combination does increase the chances of companies remaining independent. In their sample of 92 hostile bids, 60 per cent of the 45 companies with an ESB and a pill remained independent compared to 34 per cent of targets without an ESB.¹⁹⁰ Furthermore, they concluded that the returns of the companies who remained independent as compared to companies sold to either the initial bidder or a third party bidder were 36 per cent less in the short run (9 months) and 55 per cent less in the long run (30 months).¹⁹¹ Their conclusions, however, are not uncontroversial. Most importantly, opponents argue that the ESB–pill combination creates a powerful bargaining chip that results in increased returns in the more numerous friendly deals which dwarf lower returns for shareholders in companies that deploy the defences to block a deal.¹⁹² Bebchuk, Coates and Subramanian have attempted to counter this with limited empirical evidence that friendly deals with ESB–pill targets do not generate positive abnormal returns.¹⁹³ By the authors' admission this empirical rebuttal is tentative given the small sample size. More importantly, it is logically inconsistent:

It seems an impossible feat of logic to argue, on the one hand, that ESBs represent 'a serious impediment to the hostile bidder seeking to gain control over the [incumbent directors] objections' and are 'extremely potent as an antitakeover device', while at the same time arguing that, on the other hand, boards are unable to use this extremely potent force to extract a better price from any genuinely interested suitor.¹⁹⁴

Subramanian has attempted to rebut this argument arguing that in practice the scope for target management to deploy this bargaining power may be limited due to, for example, the existence of other similar purchase options for the bidder or the absence of plausible other buyers.¹⁹⁵ However, whilst Subramanian demonstrates that these case-contingent factors can affect the value range in which bargaining can take place, his analysis demonstrates necessarily that there will be cases in which the bargaining range is broad and

¹⁸⁸ An effective staggered board is one that cannot be removed by unilateral shareholder action. For example, a staggered board would be ineffective if provided for by the by-laws, which can usually be amended by the board or by the shareholders acting alone (s 109 DGCL), rather than in the charter which requires board and shareholder approval (242(b) DGCL).

¹⁸⁹ Bebchuk et al (n 132).

¹⁹⁰ *ibid* 930.

¹⁹¹ *ibid* 936.

¹⁹² *eg see* M Gordon, 'Takeover Defenses Work. Is That Such a Bad Thing?' (2002) 55 *Stanford Law Review* 819, 823, 837.

¹⁹³ LA Bebchuk, JC Coates, and G Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants' (2002) 55 *Stanford Law Review* 855, 906–8.

¹⁹⁴ Gordon (n 192) 824.

¹⁹⁵ *See* Subramanian (n 131) 641–66.

where the ESB–pill bargaining power can be deployed. The overall value implications of the ESB–pill combination, therefore, remain unresolved.

The value debate in the United States, therefore, does not provide Rule 21 with a convincing existential rationale. It remains a moot point whether takeover defences generate or destroy shareholder value. More problematic for Rule 21 is that the limited US evidence of value destruction is either inapplicable or less relevant to the UK. Bebchuk, Coates and Subramanian's evidence that ESB–pill combinations are value-decreasing does not travel to the UK. In the UK staggered boards and with-cause removal of directors are not available, and this, as demonstrated above, substantially strips the pill of its potency. Evidence that reorganization defences are value-decreasing should also be viewed as context-specific. Several of the restructurings studied by Dann and DeAngelo would not be available in the UK without ex-post shareholder approval because they involved share issues and buy-backs, and divestures and acquisitions that would have exceeded the UK's 25 per cent threshold.¹⁹⁶ Furthermore, as noted above, the possible removal threat post-failed bid may well have been much lower in the US cases studied than it would have been in the UK due to the existence in the subject firms of staggered boards and with-cause removal. If, as Dann and DeAngelo suggest, entrenchment does explain the negative returns in the reorganization cases which they analyse, it is not clear that the different set of UK background rules would not control any entrenchment temptation. Indeed it is very plausible that in the UK legal environment any value-decreasing entrenchment effects of ETDs are neutralized by the mandatory set of background rules, allowing value-positive effects to dominate. Unfortunately this hypothesis is not testable so long as Rule 21 is in force.

IV. CONCLUSION

In the contemporary company law setting in which UK public companies operate, Rule 21 has a very limited impact. If the regulator's policy goal is the prohibition of post-bid board-controlled takeover defences deployed without post-bid shareholder approval, it has practical effect only in relation to a limited set of reorganization and asset sale defences and only where the company has a constitutional settlement that allows the board to use corporate powers to defensive effect. But as has been established, the same background company law rules which would disable more potent defences such as poison pills ensure that available defences would only be used where management were convinced that the shareholder body, or at least the active members of the shareholder body, accepted the legitimacy of such action, even if they would prefer to accept the offer. Accordingly, in the absence of the non-frustration

¹⁹⁶ See Dann and DeAngelo (n 184) 116–26.

prohibition not only would post-bid, director-controlled ETDs require pre-bid shareholder consent but when made available there is limited scope to use them for entrenchment purposes. If this is the case Rule 21 struggles to rationalize its existence. This article has looked for but found no such rationale. In the context of UK company law, the non-frustration rule is unnecessary and without justification.