1990

# Corporate Control: Markets and Rules

Caroline Bradley
*University of Miami School of Law*, cbradley@law.miami.edu

# Corporate Control: Markets and Rules

*Caroline Bradley**

## 1. Introduction

It is likely that the impact of statutes on transactions in corporate control in the United Kingdom will increase in the near future, whether as a result of recent scandals or because of the introduction of legislation to harmonise rules within the EEC.[1] For these reasons it is appropriate to consider again the interests of those who are affected by the operation of the market for corporate control.

Traditionally, comment on, and regulation of, take-overs has focused on three issues: (1) the maintenance of proper balances between managerial and ownership interests within companies which are the targets of take-over attempts, (2) the maintenance of a balance between the interests of predators and shareholders in the target company, and (3) the protection of the public interest. The first issue can be traced to the identification by Berle and Means of a potential conflict between the interests of owners and the interests of controllers of large corporations. Since Berle and Means, much of the literature about corporations has concentrated on whether constraints on corporate managerial power are necessary in order to protect the interests of shareholders.[2] One of the most significant constraints on corporate managerial power seems to many commentators to be the market for corporate control, and the threat of displacement which it poses to corporate managements.[3] The idea of the market for corporate control seems to have originated with Berle and Means,[4] but has since been refined.[5] The second issue arises out of the concern of regulators that predators should not profit at the expense of target company shareholders,[6] and some of the refinements of the corporate control theory are relevant to this issue. In practice, the third issue, the protection of the public interest, usually involves questions of competition policy.[7]

These three issues all have different origins, but economic theory is relevant in all cases, as it suggests that markets operate in the public interest, except where there is market

---

*Law Department, London School of Economics and Political Science.

1 Statutes already affect transactions in corporate control. See, for example: The Fair Trading Act 1973; sections 146–153 of the Companies Act 1989. On suggestions that the system of regulation of take-overs will change, see, for example: Gower 'Big Bang and City Regulation' [1988] 51 MLR 1, pp.19–20; The Annual Report of the Takeover Panel for the year ended 31st March 1988; *EC Proposal for a Thirteenth Company Law Directive Concerning Takeovers. A Consultative Document* DTI, August 1989, pp.7–12.

2 See, for example: Berle and Means *The Modern Corporation and Private Property* (New York: The MacMillan Company 1933); Fama and Jensen 'Separation of Ownership and Control' 26 J. L. and Econ 301 (1983); Williamson 'Organisation Form, Residual Claimants, and Corporate Control' 26 J.L. and Econ, 351 (1983); Victor Brudney 'Corporate Governance, Agency Costs and the Rhetoric of Contract' 85 Col. L. Rev. 1403 (1985); Helm, 'Mergers, Take-overs, and the Enforcement of Profit Maximization' in Fairburn and Kay (eds), *Mergers & Merger Policy* (Oxford: Oxford University Press 1989).

3 'The Government believe that the threat of take-over is a powerful spur towards efficiency in the management of UK Companies.' *Mergers Policy. A Department of Trade and Industry Paper on the policy and procedures of merger control.* (1988) at para. 2.27.

4 See Berle and Means, note 2 above, p.287.

5 See, for example: Manne 'Mergers and the Market for Corporate Control' (1965) *Journal of Political Economy* 110; Manne 'Some Theoretical Aspects of Share Voting' 64 Col. L. Rev. 1427 (1964); Marris *The Economic Theory of 'Managerial' Capitalism* (London: MacMillan & Co Ltd 1964); Easterbrook and Fischel 'Corporate Control Transactions' 91 Yale L. J. 698 (1982); Comment and Jarrell 'Two-Tier and Negotiated Tender Offers. The Imprisonment of the Free-riding Shareholder' 19 *Journal of Financial Economics* 283 (1987).

6 See, for example: The Takeover Panel *Guinness PLC. The Distillers Company PLC* 14 July 1989.

7 See text at note 103 below.

failure, such as insufficient competition, or external social costs.[8] Recent suggestions that the traditional approach to take-overs does not take adequate account of the interests of predator company shareholders, employees and suppliers of the target company, the local community and the public interest[9] are suggestions that take-overs involve external social costs, which should be eliminated or internalised.

This article describes the market for corporate control theory, and the implications of this theory for the interests of investors in the target company, and investors in the predator (if it is a company), and of other affected groups. Current rules which affect the interests of these various groups are described, and I suggest ways in which the current rules could be amended in order better to protect the interests of those who may be threatened by the operation of the market for corporate control. These issues are often ignored in the context of a regulatory system which has developed in response to perceived abuses in the market place.[10]

## 2. The Market for Corporate Control

The theory of the market for corporate control is that 'inefficient managers, if not responsible to, and subject to displacement by, owners directly, can be removed by stockholders' acceptance of take-over bids induced by poor performance and a consequent reduction in stock value'.[11] The market for corporate control is supposed to reduce the risk, identified by Berle and Means, that managers may satisfice or engage in non-profit maximising behaviour[12] and to ensure that resources are allocated efficiently.[13]

The foundation of the market for corporate control theory is the relationship between the activities of a company's management and the price of its shares.[14] Inefficient managers do not take feasible action to maximise the price of the company's shares,[15] and where the management of a company is inefficient in this sense the price of shares in that company fails to reflect the company's true potential. This creates a 'control opportunity', an opportunity for a predator to acquire control of the company and appoint a new management which will act to maximise the share price, and, in so doing, produce

8 See, for example: Stone *Regulation and its Alternatives* (Washington DC: Congressional Quarterly Press 1982).

9 See, for example: Greene and Junewicz 'A Reappraisal of Current Regulation of Mergers and Acquisitions' 132 U. Pa. L. Rev. 647–739 (1984) pp.732–5; Coffee 'Shareholders Versus Managers: the Strain in the Corporate Web' 85 Mich. L. Rev. 1 (1986) p.12; *Takeovers and Mergers. A GMB Plan for Action.* General, Municipal Boilermakers and Allied Trades Union, May 1987; *A Market with Rules: Regulating Takeovers, Mergers and Monopolies* Labour Finance and Industry Group, 1988.

10 See, for example: Statement of the Panel on Take-overs and Mergers 'Guinness PLC' 30 January 1987; Joint Statement of The Stock Exchange and of the Panel on Take-overs and Mergers 30 January 1987.

11 Herman *Corporate Control, Corporate Power* (Cambridge: Cambridge University Press 1981) p.10.

12 See, for example: Manne 'Some Theoretical Aspects of Share Voting' Note 5 above, p.1432.

13 See, for example: Manne 'Mergers and the Market for Corporate Control' Note 5 above at p.119. Manne suggests that other benefits of the market for corporate control are the lessening of costly bankruptcy proceedings, more efficient management of corporations and protection to non-controlling corporate investors, and consequent impact on the liquidity of the market in shares.

The Department of Trade and Industry has endorsed the role of the market in ensuring efficient allocation of resources. See: *Mergers Policy. A Department of Trade and Industry Paper on the Policy and Procedures of Merger Control*, note 3 above, and *DTI — the Department for Enterprise* Cm 278 (1988) para 2.9.

14 See, for example: Manne 'Mergers and the Market for Corporate Control' note 5 above; Ryngaert 'The Effect of Poison Pill Securities on Shareholder Wealth' 20 *Journal of Financial Economics* 377 (1988); Dann and De Angelo 'Corporate Financial Policy and Corporate Control. A Study of Defensive Adjustments in Asset and Ownership Structure' 20 *Journal of Financial Economics* 87 (1988).

15 Manne 'Some Theoretical Aspects of Share Voting' Note 5 above, p.1431, note 11. If efficiency is defined as the failure to take action to maximise the price of shares in a company it is not surprising if there is a correlation between management efficiency and share price.

capital gains for the predator. The removal of the 'inefficient' management by the predator reinforces the threat of displacement to the managements of other companies which might be tempted to engage in inefficient behaviour.[16]

There are various explanations for the willingness of predators to pay large premia for shares in target companies. They may be paying more than the shares are worth,[17] or the market price of the target's shares may underprice the underlying assets for some reason,[18] or the predator may have identified a more valuable use for the target's assets.[19]

If the predator is a company, its management may be seeking to acquire the target in order to promote its own interests. Despite this, most, if not all, of the arguments a predator could advance to promote a proposed acquisition if its proposal were challenged may be seen as varieties of the managerial inefficiency claim. For example, a predator which claims that an acquisition will create synergy and which is prepared to pay a premium over current market price for shares in the target is suggesting that the existing target management could have increased the target's share price by identifying the same synergy.[20]

Anything which makes the process of acquiring control more expensive, including regulation, interferes with the market for corporate control,[21] because a rational predator will balance the costs of a take-over against the prospective benefits to be derived from that take-over. In order for the market for corporate control to work, the predator must be able to acquire control of the target company for less than the profit it will make by remedying the existing management's inefficiency to the company.[22] Increasing the costs involved in implementing take-overs could, therefore, deprive society of the benefits associated with such transactions.

## 3. Drawbacks of the Market for Corporate Control

The idea that the market for corporate control functions as a threat to the management of companies and therefore benefits shareholders, and society, by ensuring that management acts efficiently and maximises profits is attractive. Although there is a lively debate as to the extent to which the market for corporate control functions as an effective discipline to corporate management, most discussion tends to focus on the fine tuning of the regulatory context in which the market operates. The debate as to the fine tuning has concentrated on two main areas, that of the defensive tactics a corporate manager may adopt, and that of equal treatment of shareholders in the target company. Other issues are also significant, however, such as the position of shareholders in the predator company (if the predator is a corporate body, rather than an individual), and the effect of take-overs

16 See, for example: Easterbrook and Fischel 'Limited Liability and the Corporation' 52 U. Chi. L. Rev. 89 (1985) p98; Chiplin and Wright *The Logic of Mergers* (London: Institute of Economic Affairs 1987) p26; and note 3 above.

17 See, for example: Roll 'The Hubris Hypothesis of Corporate Takeovers' 59 *Journal of Business* 197 (1986).

18 See, for example: Kraakman 'Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive' 88 Col. L. Rev. 891 (1988).

19 See, for example: Chiplin and Wright *The Logic of Mergers*, note 16 above, pp 23–25.

20 On the synergy theory of take-overs, see, for example: Bradley, Desai and Kim 'Synergistic Gains from Corporate Acquisitions and their Division between Shareholders of Target and Acquiring Firms' 21 *Journal of Financial Economics* 3 (1988).

21 See, for example: Fischel 'Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers' 57 Tex. L. Rev. 1 (1978) p. 26; Jarrell and Bradley 'The Economic Effects of Federal and State Regulations of Cash Tender Offers' 23 J. L. & Econ. 371 (1980); Ryngaert 'The Effect of Poison Pill Securities on Shareholder Wealth', note 13 above, p. 384.

22 On the calculation of the control premium see, for example: Leebron 'Games Corporations Play: A Theory of Tender Offers' 61 N.Y.U.L. Rev 153 (1986) p. 163–5; Huang and Walkling 'Target Abnormal Returns Associated with Acquisition Announcements. Payment, Acquisition Form and Managerial Resistance' 19 *Journal of Financial Economics* 329 (1987).

on other constituencies, such as employees of the target company, consumers, the local community and society as a whole. I will consider the impact of the market for corporate control on three separate groups: target investors, predator investors, and others.

## *Target Investors*

While the market for corporate control may provide an opportunity for some investors to sell out of a target company subject to an inefficient management at a price which reflects the potential profit available to the acquirer, the market for corporate control also creates an incentive for the management of a target company to act in certain ways which are not likely to benefit investors. A corporate management faced with either a remote, or an immediate, threat of take-over may respond either by taking action to maximise the price of shares in the target company, or by acting so as to inhibit a change of control. For example, in order to increase the price of shares in the company, the management may decide to change the gearing of the company.[23] Alternatively, action which would drastically increase the consideration a predator would need to pay in order to obtain control tends to inhibit a change of control. Both types of response may be characterised as defensive tactics, because both responses may be designed to protect management from the threat of displacement through take-over.

The question whether the management of a company which is subject to a hostile take-over bid should be prohibited from implementing defensive tactics in the face of that bid has received much attention.[24] An example of such tactics would be an issue of shares to a 'White Knight', who, the incumbent management hopes, will not sell them, made after a potential predator has been identified. The setting up of a new large shareholder interest of this nature will inhibit the ability of the predator to obtain control of the target. Commentators advocate the restriction of the ability of management to implement defensive tactics because they believe that the decision as to whether there is a change in the control of a company should be made by the shareholders in that company rather than by its management.[25]

Some commentators have considered whether a prohibition on the implementation of defensive tactics should extend to general defensive tactics as well as specific tactics.[26] I use the phrase 'general defensive tactics' to describe action which is designed to make a company unattractive to any potential predator, and which is taken before any specific potential predator has been identified.[27] An example of such tactics would be a provision

23 See, for example: Kraakman 'Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive' 88 Col. L. Rev. 891 (1988) pp. 916–919; Dann and De Angelo 'Corporate Financial Policy and Corporate Control' 20 *Journal of Financial Economics* 87 (1988).

24 The approaches adopted by commentators vary. See, for example: Lynch and Steinberg 'The Legitimacy of Defensive Tactics in Tender Offers' 64 Cornell L. Rev. 901 (1978); Williamson 'On the Governance of the Modern Corporation' 8 Hofstra L. Rev. 63 (1979); Bebchuk 'The Case for Facilitating Competing Tender Offers' 95 Harv. L. Rev. 1028 (1982); Easterbrook and Jarrell 'Do Targets Gain from Defeating Tender Offers?' 59 N.Y.U.L. Rev. 277 (1984); Jarrell 'The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?' 28 J. L. and Econ. 151 (1985).

25 See, for example: Easterbrook and Fischel 'The Proper Role of a Target's Management in Responding to a Tender Offer' 94 Harv. L. Rev. 1161 (1981) p. 1198.

26 See, for example: De Angelo and Rice 'Antitakeover Charter Amendments and Stockholder Wealth' 11 *Journal of Financial Economics* 329 (1983); Linn and McConnell 'An Empirical Investigation of the Impact of "Antitakeover" Amendments on Common Stock Prices' 11 *Journal of Financial Economics* 361 (1983); Malatesta and Walkling 'Poison Pill Securities, Stockholder Wealth, Profitability and Ownership Structure' 20 *Journal of Financial Economics* 347 (1988); Jarrell and Poulsen 'Dual Class Recapitalisations as Antitakeover Mechanisms. The Recent Evidence' 20 *Journal of Financial Economics* 129 (1988); Ruback 'Coercive Dual-Class Exchange Offers' 20 *Journal of Finanical Economics* 153 (1988).

27 An example of such tactics would be the implementation of a poison pill defence before a take-over is imminent. See Gilson 'A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers' 33 Stan. L. Rev. 819 (1981) p. 888.

in the company's constitution giving to the shareholders the right to be bought out at a substantial premium on a change of control.[28] Such tactics are thought by many commentators to be less objectionable that specific defensive tactics as they are usually adopted with the consent of a majority of the shareholders in the company concerned.[29]

Once a predator appears, a corporate management may act to ensure that an auction is initiated and control of the company is transferred to the highest bidder.[30] However, corporate managements could claim to be initiating an auction to benefit shareholders when, in fact, they were implementing defensive tactics to protect their own position. Even if a corporate management were genuinely promoting an auction, its actions could deprive shareholders of the opportunity to benefit from a share in the premium for the passing of control, could remove the threat to the management of the company, and could also lead to a reduction of the number of offers in future.[31]

### *Conclusion*

The market for corporate control should benefit investors in companies whose managements do not actively try to increase the price of shares in the company by offering to such investors the opportunity of escaping from the company or remaining in the company with a new management which will try to increase the share price. If a change of control could not take place, the investors could only escape from the company by selling their shares at a price depressed by the management's inaction. However, the existence of the market for corporate control may not adequately protect the interests of target investors if corporate managements are free to act in ways which, while protecting their own interests, harm the interests of some or all of the investors in the target.

## *Predator Investors*

There is a limited recognition by commentators that all companies are potential targets. Predator behaviour is supposed, under the theory of the market for corporate control, to be the mechanism which disciplines inefficient managements. However, in practice it may be used by management as a means to ward off market discipline. Some empirical studies[32] suggest that the most effective defence against take-over is the attainment of great size, and it is possible to view the action of management in promoting a policy of growth through acquisition rather than pursuing organic growth as self-serving rather than

28 Cf Rule 9 of the City Code on Take-overs and Mergers (the 'Code').

29 Commentators and regulators who consider general defensive tactics to be less objectionable than specific defensive tactics do so because of the consent of shareholders, rather than because there is no immediate threat to the management of the company. Specific defensive tactics which are adopted in with the consent of a majority of the target company's shareholders are generally considered to be harmless. See, for example, the Code, Rule 21; Malatesta and Walkling 'Poison Pill Securities. Stockholder Wealth, Profitability and Ownership Structure' 20 *Journal of Finanical Economics* 347 (1988) pp. 348–9; Jensen and Ruback 'The Market for Corporate Control. The Scientific Evidence' 11 *Journal of Financial Economics* 5 (1988) p. 33; Brickley, Lease and Smith Jr. 'Ownership Structure and Voting on Antitakeover Amendments' 20 *Journal of Financial Economics* 87 (1988) pp. 96–97. But see, for example: Ruback 'Coercive Dual-Class Exchange Offers' 20 *Journal of Financial Economics* 153 (1988) p. 154: 'Shareholders approve antitakeover provisons because such approval is the least costly alternative presented.'

30 See, for example: Bebchuk 'The Case for Facilitating Competing Tender Offers' 95 Harv. L. Rev. 1028 (1985).

31 Easterbrook and Jarrell 'Do Targets Gain from Defeating Tender Offers?' 59 N.Y.U.L. Rev. 277 (1984); c.f. Jarrell 'The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?' 28 J.L. and Econ. 151 (1985).

32 See, for example: Singh *Take-overs: their relevance to the Stock Market and the Theory of the Firm* (Cambridge: Cambridge University Press 1971); Mueller *The Determinants and Effects of Mergers. An International Comparison* (Cambridge, Massachusetts: Oelgeschlager, Gunn & Hain, Publishers, Inc. 1980); Mueller *The Modern Corporation. Profits, Power, Growth and Performance* (Lincoln: University of Nebraska Press 1986).

serving the interests of investors in the company. The attraction of the advantages of managing a larger enterprise, coupled with the lure of insulation from the danger of displacement through take-over may suggest that management should not be regarded as competent to make this type of business decision.[33] One way of protecting shareholders from the activities of managements keen on pursuing aggressive acquisition policies in order to improve their own position would be the adoption of a rule to disqualify management from making acquisition decisions without the consent of the shareholders.

There is some debate about whether take-overs do, in practice, benefit acquiring firms. Empirical studies of the reaction of share prices to announcements of take-over bids show that shareholders in predator companies do not lose when their companies are involved in take-overs.[34] However, there is other evidence to suggest that take-overs do not always produce the benefits they are alleged to produce.[35]

Not all commentators accept that take-overs involve management in a significant conflict of interest. Some take the view that the decision to implement an acquisition policy involves no more of a conflict between the interests of management and investors than any other business decision.[36] The weakness in this argument is that a management which tends to make bad or self-interested business decisions will not be disciplined by the market for corporate control if it makes business decisions putting it beyond the reach of the threat posed by the market for corporate control. The model of the market for corporate control assumes the existence of market discipline, but its existence may in fact increase the risk that management will act in its own interests, rather than reducing that risk.

In recent years evidence has been collected to suggest that large conglomerates are subject to a threat of break-up or demerger acquisitions.[37] Corporate managements seem to pursue acquisitions in order to protect their companies from the threat of take-over, but at some point the nature of the conglomerate, produced by these acquisitions, seems to render it vulnerable to the threat of take-over, so that it may be broken up. Where a conglomerate is subject to the threat of a demerger take-over, this suggests that acquisitions which produced the conglomerate in the first place failed to increase efficiency. The phenomenon of break-up take-overs seems to be desirable in the interests of increased efficiency: these transactions are an example of the market for corporate control reasserting itself. Take-overs do, however, involve transaction costs, and this process involves an increased number of take-overs, so it would be preferable if take-overs which fail to increase efficiency did not occur in the first place.

## *Social Costs of Take-overs*

Private gains from take-overs may be made at the expense of groups not directly involved

33 See, for example: Roll 'The Hubris Hypothesis of Corporate Take-overs' note 17 above; Dent Jr. 'Unprofitable Mergers: Towards a Market-Based Legal Response' 80 N.W.U.L. Rev. 777 (1986) p. 782.

34 See, for example: Asquith, Bruner and Mullins Jr. 'The Gains to Bidding Firms from Merger' 11 *Journal of Financial Economics* 121 (1983); Jensen and Ruback 'The Market for Corporate Control. The Scientific Evidence' 11 *Journal of Financial Economics* 5 (1983) pp. 16–22; Chiplin and Wright *The Logic of Mergers* note 16 above, pp. 68–70.

35 See, for example: Roll 'The Hubris Hypothesis of Corporate Takeovers' note 17 above; Chiplin and Wright *The Logic of Mergers* note 16 above, pp. 65–68; *Mergers Policy. A Department of Trade and Industry Paper on the policy and procedures of merger control* (1988) at para 2.10: 'The bulk of the evidence ... is that the commercial performance of enterprises post-merger has, more often than not, failed to live up to the claims of the acquiring firm at the time of the merger.'

36 Fischel 'Efficient Capital Market Theory, The Market for Corporate Control and the Regulation of Cash Tender Offers' 57 Tex. L. Rev. 1 (1978) p. 43, note 147.

37 See, for example: 'Takeover Activity in the 1980s' *Bank of England Quarterly Bulletin* February 1989 78, 79; Coyne and Wright (eds), *Divestment and Strategic Change* (Oxford: Philip Allan Publishers Limited 1986); Wright, Chiplin and Coyne, 'The Market for Corporate Control: the Divestment Option' in Fairburn and Kay (eds), *Mergers & Mergers Policy* note 2 above.

in the transactions.[38] The costs involved may be of two types: transition costs necessarily involved in the change from an inefficient use of resources to a more efficient use of resources, and other costs.

The activities of those involved in the market for corporate control may harm the interests of groups such as consumers, creditors and investors in the stock market. The public interest may also be affected, for example in relation to research which is not undertaken in the private sector as a result of the existence of the market for corporate control. Whether financial markets are excessively affected by short term considerations or not,[39] corporate managers may believe in short termism and decide not to invest in long term research projects because of the risk that such investment would have a negative impact on share price. A corporate predator which pays more for control of target companies than that control is worth increases the risk that it will either become insolvent and go into liquidation or that it will become a target for a 'break-up' take-over.[40] If the company becomes insolvent the interests of creditors may be adversely affected. A break-up take-over may remove some of the costs involved in a liquidation, but will involve other costs.

Although take-overs seem to involve some social costs, various factors do operate to limit the effect of these costs. The company is at a 'confluence of multiple markets',[41] and the operation of these markets will tend to constrain the activities of the managements of the predator and target. For example, in the absence of a monopoly situation, competition in the product market will operate to ensure the maintenance of the quality of the product, and that the price of the product does not increase excessively. Competition rules apply to protect the product markets, although such rules tend not to be applied to conglomerate mergers as stringently as to horizontal and vertical mergers.[42]

In practice, some acquisitions result in an increase in the level of debt of the combined enterprise.[43] An increase in the level of debt of an enterprise may increase the risk to existing creditors of that enterprise. Mervyn King recognises this cost to third party creditors, but suggests such costs as exist are costs related to gearing, rather than costs related to highly leveraged take-overs.[44]

If the acquisition significantly increases the power of the combined entity in the markets in which it operates, the predator might engage in monopolistic practices. For example, it might manufacture goods of worse quality, increase the price it charges for goods or

38 On social costs, see, for example: Coase 'The Problem of Social Cost' 3 JL & Econ. 1 (1960); Calabresi 'Transaction Costs, Resource Allocation and Liability Rules — A Comment' 11 JL & Econ. 67 (1968); Buchanan and Faith 'Entrepreneurship and the Internalization of Externalities' 24 JL & Econ. 95 (1981); Ullmann, 'The Structure of Social Costs' in Ullmann (ed), *Social Costs and Modern Society* (Westport, Connecticut: Quorum Books 1983).

39 See, for example: Chiplin and Wright *The Logic of Mergers* note 16 above, pp. 53–55.

40 See, for example: Monopolies and Mergers Commission *Lonrho Limited and House of Fraser Limited.* HC 73 (1981) The Commission considered, at para. 7.52, that there was 'at least a very real and substantial risk that the efficiency of House of Fraser would deteriorate seriously as a result of the merger, and that it would be detrimental to the public interest that it should be exposed by the merger to such a risk'.

41 Coffee Jr. 'Shareholders versus Managers: The Strain in the Corporate Web' 85 Mich. L. Rev. 1 (1986) p. 100.

42 See, for example: Monopolies and Mergers Commission *Lonrho Limited and Scottish and Universal Investments Limited and House of Fraser Limited.* HC 261 (1979) at para. 8.18: because Lonrho and Scottish and Universal Investments were conglomerates no issues of restriction or distortion of competition arose. For comments on the issues raised by conglomerate mergers see Monopolies and Mergers Commission *Blue Circle Industries Limited and Armitage Shanks Group Limited* Cmnd 8039 (1980) at paras. 8.29 to 8.34.

43 See for example King, 'Takeover Activity in the United Kingdom' in Fairburn and Kay (eds), *Mergers & Merger Policy* note 2 above, pp. 108–110; Taggart Jr, 'The Growth of the "Junk" Bond Market and its Role in Financing Takeovers' in Auerbach (ed), *Mergers and Acquisitions* (Chicago: University of Chicago Press, 1988).

44 King, 'Take-over Activity in the United Kingdom' in Fairburn and Kay (eds), *Mergers & Merger Policy* note 2 above, p. 110.

services, and increase the length of time it takes to pay its bills. In the short term such actions could be harmful to consumers and suppliers. Other actions the predator might take after the acquisition could include the centralisation of the combined entity's operations in one site, or the reduction of investment in research and development.

The interests of groups other than investors in the target company and the predator company are likely to be affected by the predator's action. Is it, therefore, appropriate for the decision whether the acquisition should go ahead to be made by the shareholders in the target company who will be offered part of the predator's anticipated profit in return for their shares?

In addition to the effects of the predator's actions on groups other than the investors in the target and in the predator itself, we should consider the effects of action by a management which is trying to insulate itself from the threat of take-over on such groups. Herman has suggested that: 'managerial capitalism may yield social inefficiencies by its better integration into an efficient capital market that heavily discounts large but uncertain long term profits (and disregards the positive social externalities of the longer view and risk-taking)'.[45]

A management which feels subject to the threat of displacement through take-over is likely to be reluctant to invest in research and development or in any activity which is unlikely to generate profits in the near future, even if the activity in question were a sensible long term strategy. If the market for corporate control does tend to discourage corporate managements from investing in projects which might result in large profit in the future in favour of projects which will result in small certain profits in the short-term, the market may not be as effective in ensuring the efficient allocation of resources as is often suggested.

The market for corporate control encourages management to take all feasible action to maximise the price of shares in the company, and could encourage management to maximise the share price through the release of information to the market or by some other means. Managements may often tread the fine line between permissible action to maximise the price of shares in their companies and unlawful market manipulation.[46] Shareholders in the company would tend to benefit from manipulation geared to maximising the company's share price, but investors in the market at large would tend to suffer as a result of such action, because market prices would not tend to reflect the true value of the shares.

## 4. The Regulatory Framework in the United Kingdom

Market mechanisms, company law and the quasi-legal provisions[47] which regulate take-overs all provide some protection of the interests of investors before and during a take-over, and, to some limited extent, protection of the interests of employees and creditors and others who may be affected by take-overs. Regulators and commentators on these

45 Herman *Corporate Control, Corporate Power* Note 10 above, p. 100.

46 Section 47 of the Financial Services Act 1986 prohibits market manipulation. However, the boundaries of the offence are uncertain. Could off-balance sheet financing amount to unlawful market manipulation? On off-balance sheet finance see Weetman 'Off-balance Sheet Finance: The Quest for an Accounting Solution' *The Investment Analyst* 89 July 1988, 4.

47 I use the word 'quasi-legal' to refer to the rules promulgated by the Panel on Take-overs and Mergers because, although the Panel has no statutory authority to make law, and the Introduction to the Code emphasises that it does not constitute law as such, the Code has had an impact on the development of the common law. See, for example: *Gething* v *Kilner* [1972] 1 WLR 337; *R* v *Panel on Take-overs and Mergers ex.p. Datafin plc* [1987] 2 WLR 699; *R* v *Panel on Take-overs and Mergers ex.p. Guinness* [1989] 1 All E R 509; and McCrudden 'Codes in a Cold Climate: Administrative Rule-making by the Commission for Racial Equality' (1988) 51 MLR 409.

various mechanisms and regulations emphasise investor protection.[48] However, the market for corporate control is, it is argued, itself a mechanism for protecting investors. In theory, the market should ensure the efficient allocation of resources: owners of capital would furnish that capital for the most efficient possible use, because the most efficient use would provide the best return for the owners of capital. In practice, no markets are unregulated. For example, the current regime applicable to take-overs in the United Kingdom involves regulation of defensive tactics[49] combined with a complete lack of regulation of the 'financial or commercial advantages or disadvantages' of a change of control.[50] Financial and commercial issues are not regulated because such issues are thought to be a matter for the company and its shareholders, unless specific questions relating to the public interest, usually involving competition policy, are raised. The refusal to regulate financial and commercial issues indicates an acceptance of the market as an appropriate decision-making process. This reinforces the market for corporate control. On the other hand the regulation of defensive tactics indicates a recognition that the market for corporate control may act against the interests of shareholders.

## Company Law

In a large company many of the directors will not be actively involved in management but will, in theory, perform the function of monitoring management.[51] In practice, directors of companies which are taken over as a result of hostile take-overs are likely to lose their directorships.[52] Although there may be a distinction between the seriousness of a threat of take-over to executive directors and to non-executive directors, in practice all directors are subject to the threat provided by the market for corporate control in the same way as other members of a company's management.

In legal theory, the fundamental duty imposed on a director is to act bona fide in what the director considers to be the best interests of the company and not for any collateral purpose.[53] In addition a director must avoid all conflicts of interest.[54] The law imposes duties on directors, rather than on management, largely because when the duties were developed there was no separation between direction and management.[55] Directors are subject to fiduciary duties,[56] duties of care and skill, and statutory duties. In addition,

48 For example: Paragraph 1(a) of the Introduction to the Code emphasises that it 'represents the collective opinion of those professionally involved in the field of take-overs as to good business standards and as to how fairness to shareholders can be achieved.' The maintenance of such standards is thought to be important to the integrity of the financial markets in the United Kingdom.

49 See the Code, General Principle 7, Rule 21.

50 See the Introduction to the Code at section 1(a).

51 See, for example: Fama and Jensen 'Agency Problems and Residual Claims' 26 J.L. & Econ. 327 (1983) p. 331; Axworthy 'Corporate Directors — Who Needs Them?' (1988) 51 MLR 273; Jensen and Ruback 'The Market for Corporate Control. The Scientific Evidence' 11 *Journal of Financial Economics* 5 (1983) p. 43.

52 For judicial recognition of this threat see *Hogg* v *Cramphorn* [1967] 1 Ch 254, 265. See also David Lodge, *Nice Work* (Secker and Warburg 1988) at p. 263: ' "What you mean," said Vic bitterly, "is that by selling off Pringle's now, you can show a profit on this year's accounts at the next AGM." Stuart Baxter examined his nails, and said nothing. "I won't work under Norman Cole," said Vic. "Nobody's asking you to, Vic," said Baxter'.

53 *Re Smith and Fawcett* [1942] Ch 304.

54 *Bray* v *Ford* [1896] AC 44. For consideration of the conflicts of interest involved in management buyouts, see, for example: Booth 'Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty' 60 N.Y.U.L. Rev. 630 (1985); Schleifer and Vishny, 'Management Buyouts as a Response to Market Pressure' in Auerbach (ed), *Mergers and Acquisitions* note 43 above. The Take-over Panel introduced new rules to deal with management buyouts in January 1990.

55 See, for example: *In re Forest of Dean Coal Mining Company* (1878) 10 Ch. D. 450, 452: directors were 'commercial men managing a trading concern for the benefit of themselves and of all the other shareholders in it'.

56 Directors' fiduciary duties are often characterised as representing the terms of the contracts investors would make with the directors if they were to negotiate such contracts. See, for example: Easterbrook

duties are imposed on directors by service contracts. For managers who are not directors, service contracts are the only basis for their duties to the company.

The basic duty of a director to act bona fide in the best interests of the company is formulated subjectively: the courts do not review directors' decisions in order to discover whether it was reasonable to consider that a particular course of action was in the interests of the company or not.[57] However, in exceptional circumstances, the directors' objectives may be taken into account in deciding whether they are exercising their powers for the proper purposes or not.[58]

The directors' objectives have been held to be a relevant consideration in relation to issues of shares the purpose of which was to prevent a change of control.[59] This doctrine, the 'proper purposes doctrine', which has so far been limited to the question of issues of shares to friendly third parties to inhibit a change of control could be extended to other defensive tactics.[60] For example, suppose a board of directors sought to ward off a potential predator by entering into onerous contracts with third parties, arguing that, in their opinion, the contracts were in the best interests of the company. If the directors were acting in good faith it would seem to be necessary to use the proper purposes doctrine in order to challenge their actions.[61] It is not clear, however, that such an action would be likely to succeed in relation to a company involved in a public market.[62] Shareholders in a target company would want to take action against the delinquent directors to prevent the use of defensive tactics, or to obtain a remedy if the directors' action were successful in preventing the take-over. However, in practice, shareholders are not likely to find out about proposed defensive tactics in time to prevent their use, and, in general, litigation about breaches of directors' duties is corporate litigation and thus usually controlled by the directors.

Even if the directors of the target company have breached their fiduciary duties in opposing a potential take-over, it is not clear that a minority shareholder will be entitled to bring an action in respect of a breach of duty owed to the company, as the company itself should sue in respect of a breach of a duty owed to the company unless one of the exceptions to the rule in *Foss* v *Harbottle* applies.[63] A minority shareholder in a target company should be able to benefit from one of the exceptions to the rule in *Foss* v *Harbottle* to prevent the directors of the company from engaging in illegal acts, for example, manipulating the market price of shares in the company.[64] The purchase or sale of large amounts of

---

and Fischel 'Corporate Control Transactions' 91 Yale L. J. 698 (1982) pp. 701–2.

57 Cf the operation of the 'business judgement rule' in the United States. See, for example: Greene and Junewicz, note 9 above p. 712; Stegemoeller 'The Misapplication of the Business Judgement Rule in Contests for Corporate Control' 76 N.W.U.L. Rev. 980 (1982); Easterbrook and Fischel 'The Proper Role of a Target's Management in Responding to a Tender Offer', note 25 above, pp. 1194–1198.

58 *Hogg* v *Cramphorn* [1967] Ch 254; *Bamford* v *Bamford* [1970] Ch 212; *Howard Smith* v *Ampol Petroleum* [1974] AC 821; *Clemens* v *Clemens* [1976] 2 All ER 268. The precise limits of the doctrine are unclear.

59 *Howard Smith* v *Ampol Petroleum* [1974] AC 821, 837. Although the company in this case appears to have been involved in a public market (see pp. 827, 828, 838) the other cases in which the proper purposes doctrine has been applied in the United Kingdom have involved unquoted companies.

60 See, for example: Gelfond and Sebastian 'Re-evaluating Duties of Target Management in a Hostile Tender Offer' 60 B.U.L. Rev. 403 (1980) at p. 415; Lofthouse 'Competition Policies as Take-over Defences' (1984) JBL 320, 333.

61 For a suggestion that shareholders have a personal right to prevent directors from acting for an improper purpose, see *Re A Company (005136 of 1986)* [1987] BCLC 82.

62 Courts in the United Kingdom are reluctant to interfere in the take-over process. See, for example: *R* v *Panel on Take-overs and Mergers ex p Guinness* [1989] 2 WLR 863, 868; *Re Ricardo Group plc* [1989] BCLC 566, 577.

63 (1843) 2 Hare 461.

64 This exception does not seem to extend to obtaining a remedy once an illegal act has occurred. See *Smith* v *Croft* [1987] 3 WLR 405. But see also section 111A of the Companies Act 1985, introduced by section 131 of the Companies Act 1989 removing barriers to remedies in damages for shareholders. If a shareholder were to have a personal right not to have the value of her shareholding affected by unlawful acts of the directors, this provision might allow a remedy in damages.

shares on the market may have significant effects on the price of such shares, and such action may amount to criminal offences such as market manipulation, purchase by a company of its own shares,[65] or financial assistance for the purchase of a company's own shares.[66] The main difficulty an investor would encounter in relation to such activity would be in discovering its existence; for example it appears that the Guinness bid for Distillers in 1987 involved a price support operation which was not discovered until well after the event, and then only by accident. Similar difficulties would arise if the directors of the company were, on the other hand, engaged in an attempt to manipulate the market by means of a selective release of information.

In addition to the difficulties of discovering what the directors were doing, a minority shareholder might find it difficult to pursue litigation during a take-over bid, partly because of the reluctance of the courts to interfere with the take-over process, and partly because it seems that the courts are reluctant to accept that litigation is an appropriate mechanism for resolving disputes within companies which are subject to public markets.[67]

Another problem created by the rule in *Foss* v *Harbottle* is that directors' duties are owed to the company, and not, as a general rule, to shareholders in the company.[68] The fraud on the minority exception to the rule in *Foss* v *Harbottle* is unlikely to apply where directors implement defensive tactics in order to preserve their position, unless the directors are involved in activities such as market manipulation. Even if a minority shareholder were held to be entitled to bring an action, other than a personal action, against directors for breach of their duties, and were to succeed in that action, any remedy would benefit the shareholder only indirectly. The remedy would go to the company, and, although an increase in the company's assets might be reflected in the market price of the company's shares, whether such an increase would compensate the minority shareholder for the loss she had sustained as a result of the directors' actions would depend on the market's perception of the adequacy of the remedy.[69]

The courts have recognised that in certain circumstances directors may owe duties directly to shareholders. For example, during a take-over offer, the duties owed by directors to shareholders include a duty to be honest, and a duty not to mislead.[70] It is conceivable that a minority shareholder could bring an action against directors who defeated a take-over attempt by means of misleading target company shareholders into believing that the offer would not provide sufficient consideration for their shares. The minority shareholder would, however, only be able to prove damage if she could show that the offer would have succeeded had it not been for the directors' misleading statements, that, apart from the statements the offer would have been accepted by holders of shares carrying at least 50% of the voting rights in the company. In practice such an action would seem to be unlikely to succeed.

The position of shareholders in a predator company is no better. The subjective formulation of the director's duty to act bona fide in the best interests of the company suggests that directors who contemplate the acquisition of another company might rely on a claim that they believed the acquisition was in the best interests of the company. However, the threat of displacement by take-over, which is reduced by the decision to become a predator, suggests that directors should not be considered competent to make

65 *Trevor* v *Whitworth* (1887) 12 App Cas 409, section 23 of the Companies Act 1985.
66 See section 151 of the Companies Act 1985.
67 See e.g. *Prudential Assurance* v *Newman Industries* [1982] Ch 204 at p. 225: 'the Prudential, not being the proper plaintiffs, had no knowledge of what had gone on inside Newman'.
68 *Percival* v *Wright* [1902] 2 Ch 421; although see *Re A Company* note 61 above.
69 A minority shareholder in a quoted company is not entitled to recover damages for a decrease in the value of the investment: *Prudential Assurance* v *Newman Industries (No 2)* [1982] Ch 204, 222, because 'such a "loss" is merely a reflection of the loss suffered by the company. The shareholder does not suffer any personal loss.'
70 *Gething* v *Kilner* [1972] 1 All ER 1166, 1170.

such decisions because of the potential conflict between their own personal interests and the interests of the shareholders. The impact of the proper purposes doctrine may extend to take-overs designed not to benefit the company but to entrench management in its position. If the directors were to argue that in their view the entrenchment of their position would be beneficial to the company, a shareholder who wished to challenge their actions would have to use arguments based on the proper purposes doctrine.

Minority shareholders in predator companies who wish to bring an action will be faced by significant procedural barriers, which are aggravated in relation to large companies. A minority shareholder in a large company will have substantial evidential and other problems in mounting litigation. After the decision of the Court of Appeal in *Prudential Assurance* v *Newman Industries*[71] the 'fraud on the minority' exception to the rule in *Foss* v *Harbottle* will not afford much assistance to a minority shareholder in a company involved in a take-over. An investor in a company which makes a take-over offer for another company because the directors believe that the take-over will increase their power, prestige and remuneration (although in fact it will actually harm the acquiring company) is unlikely to be able to show that such action amounts to a fraud on the minority by those in control. Such action would not fall in the same category as cases involving an actual misappropriation of corporate property.[72] Unless there is an express provision requiring shareholder consent to proposed take-overs creating a personal right for shareholders, or the directors engage in some type of illegal activity in order to promote the take-over, a minority shareholder is therefore unlikely to be able to challenge such action.

Present rules fail to recognise that a minority shareholder in a predator does have an interest in whether a take-over attempt is pursued or not because a successful take-over will result in a transfer of wealth from the predator shareholders to the target shareholders.[73]

As things stand, a minority shareholder in a predator company is even less likely to be able to challenge actions of the directors in relation to takeovers than a minority shareholder in a target company. One way of reducing the impact of the rule in *Foss* v *Harbottle* in this area would be to grant to shareholders personal rights to decide on particular types of action.[74] Amendment of the Articles of Association of a company to require shareholder approval by a special majority before particular actions such as making a take-over bid or implementing defensive tactics would allow minority shareholders to litigate if the requirement were not complied with,[75] at the cost of constraining the operation of the market for corporate control. Such a rule could enhance the ability of minority shareholders, if not to monitor management activity, at least to ensure that management took adequate account of the interests of minority shareholders during a take-over bid. On the other hand, such a solution would only be effective if the courts would recognise such a personal right, if shareholders were able and willing to litigate, and if management believed that litigation would be likely if they did not comply with the requirement.

## *The City Code on Take-overs and Mergers*

Because, in practice, the impact of company law on take-overs is limited, the City Panel on Take-overs and Mergers developed the Code to regulate the conduct of take-overs. The aim of this body of quasi-legal rules is: 'to ensure fair and equal treatment of all

71 [1982] Ch 204.

72 See, for example: *Cook* v *Deeks* [1916] 1 AC 554.

73 Nor is there any recognition of this potential threat to predator shareholders in the Code, which assumes that take-overs threaten target shareholders, rather than predator shareholders.

74 An example of the application of the personal rights exception to the Rule is *Edwards* v *Halliwell* [1950] 2 All ER 1064.

75 *Edwards* v *Halliwell*, see note 74 above, is also an example of the special procedure/special majority exception to the rule.

shareholders in relation to take-overs'.[76] The General Principles contained in the Code emphasise this aim,[77] and the Code contains detailed requirements as to the procedures which must be followed during a take-over transaction,[78] and as to the information which must be provided to shareholders.[79] The requirements contained in the Code relating to the disclosure of information are subject to the criticisms which apply to any disclosure requirements, namely that it is not evident that the costs of imposing the requirements outweigh the benefits produced by the requirements and that the information required to be disclosed is not necessarily of use to shareholders.[80] Empirical measurement of the costs and benefits associated with such requirements is, of course, problematic.

One of the most important elements in the Code is the requirement that in certain circumstances a 'mandatory offer' be made.[81] The aim of this requirement is to ensure that all shareholders in the offeree company may share in the premium for control, by requiring a general offer to be made to shareholders in the target company on a change of control. The level of consideration offered to target shareholders must equal the highest price paid for shares of the same class in the target company in the twelve months preceding the bid.

It is possible that a requirement of this nature increases the cost to predators of acquiring the control of target companies. Although the aim of the rule is to ensure that the premium for control is not paid to one or more shareholders who actually transfer control, but is shared among all of the shareholders in the target company,[82] it is arguable that the expense incurred by predators in preparing formal offer documents exceeds the benefits provided to minority shareholders by the mandatory offer, and that the high cost of acquiring control may discourage many transactions which might benefit target company shareholders. Even if there were no rule requiring a predator to make a mandatory offer, minority shareholders in target companies would still seem to be in no worse position after a change of control than they were under the previous 'inefficient' management. Indeed, if the predator is to avoid future take-overs by other predators it will have to increase the company's share price, which presumably benefits minority shareholders.

So long as the target company remains part of a public market, therefore, minority shareholders in the target company are subject to no greater risk than they were before the change of control. By contrast, if the change of control involves a 'going private' transaction, minority shareholders whose position was adversely affected by a successful predator's actions can bring an action against the predator claiming that the predator's conduct was unfairly prejudicial to their interests.[83] The existence of this remedy should deter predators from acting in ways which prejudice the interests of minority shareholders.

The minority shareholders in the target company will suffer loss as a result of the change of control only if the predator is able to use its position to benefit itself at the expense of the minority shareholders. The predator could, for example, strip the assets of the target company and transfer the proceeds to itself, leaving the minority shareholders with an

---

76 See the Introduction to the Code at Section 1(a).

77 See e.g. General Principles 1, 4, 5.

78 See e.g. Rules 1, 2, 9–11, 30–32.

79 See e.g. General Principles, 4, 5, and Rules 19, 23–29.

80 See, for example: Kripke 'A Search for a Meaningful Securities Disclosure Policy' 31 *Business Lawyer* 293 (1975).

81 See Rule 9.

82 On equal treatment in sales of control see, for example: Leech 'Transactions in Corporate Control' 104 U. Pa. L. Rev. 725 (1956); Jennings 'Trading in Corporate Control' 44 Calif. L. Rev. 1 (1956); Brudney and Chirelstein 'Fair Shares in Corporate Mergers and Takeovers' 88 Harv. L. Rev. 297 (1974); Cohn 'Tender Offers and the Sale of Control: An Analogue to Determine the Validity of Target Management Defensive Measures' 66 Iowa L. Rev. 475 (1981); Bebchuk 'Toward Undistorted Choice and Equal Treatment in Corporate Takeovers' 98 Harv. L. Rev. 1693 (1985).

83 See section 459 of the Companies Act 1985.

interest in a mere shell.[84] Rules which protect the right of shareholders to receive dividends,[85] which protect the holders of class rights from variation of their rights without their consent,[86] and which require new issues of shares to be made pro rata to existing shareholdings[87] reduce this risk. Such rules, if enforced, reduce the risk posed to minority shareholders in a target company.

The Code also deals with the question of directors' conflicts of interest. General Principle 9 provides that 'Directors of an offeror and the offeree company must always, in advising their shareholders, act only in their capacity as directors and not have regard to their personal or family shareholdings or to their personal relationships with the companies. It is the shareholders' interests taken as a whole, together with those of employees and creditors, which should be considered when the directors are giving advice to shareholders.' In addition to this general provision, the Code prohibits the directors of the offeree company from taking action 'which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits'.[88] The Code also contains specific examples of action which falls within the prohibition[89] but in the light of the Code's emphasis on the spirit rather than the letter of its provisions[90] the prohibition would seem to cover any possible defensive tactic which a board of directors might think of adopting in the face of a bid. The provisions of the Code do not, however, restrict the ability of companies to adopt general, as opposed to specific, defensive tactics because they apply only after the board 'has reason to believe that a bona fide offer might be imminent'.[91] A general policy of pursuing growth through acquisition to avoid becoming a target would not be affected by the rule. This rule is expressed sufficiently restrictively to prevent directors of target companies from acting to encourage auctions because such action 'could effectively result in' a 'bona fide offer being frustrated'.[92] This rule should protect shareholders in target companies from action by directors of target companies aimed to prevent a take-over from succeeding. In this way the rule reinforces the market for corporate control.

Shareholders in target companies have little legal protection against defensive mechanisms designed to defeat the operation of the market for corporate control. Although there is a continuing debate about whether the Code is an effective regulatory system,[93] the Code fills this gap by providing significant, if not excessive, benefits to such shareholders. Predator shareholders are not protected by the Code. On the other hand, the transaction costs imposed on predators by the Code may discourage transactions which might benefit target shareholders.

The Monopolies and Mergers Commission has recently suggested that 'the Department of Trade and Industry and the appropriate City regulatory authorities might consider whether any change is desirable in the rules in order to require the consent at a General Meeting of the shareholders of the bidding company before a bid may be completed.'[94] The Commission thought that the interests of shareholders in the bidding company were affected by highly leveraged bids.

84 Regulators have developed rules to prevent asset stripping in order to maintain public confidence in the markets. However, to an economist, asset stripping is not necessarily an undesirable practice as it involves the transfer of resources to a more efficient use. See, for example: *Mergers Policy. A Department of Trade and Industry Paper on the policy and procedures of merger control.* (1988) at para 2.25.

85 See, for example: *Re A Company (No. 00370 of 1987) ex p Glossop* [1988] 1 WLR 1068.

86 See sections 125–129 Companies Act 1985.

87 See sections 89–96 Companies Act 1985.

88 General Principle 7.

89 See Rule 21.

90 See the Introduction to the General Principles.

91 See General Principle 7.

92 See General Principle 7.

93 See, for example: Hurst 'Self Regulation versus Legal Regulation' (1984) 5 Co. Law. 161.

94 *Elders IXL Ltd and Allied-Lyons plc* Cmnd 9892 (1986) at para 8.54.

### *The Response of Regulation to Social Costs*

Although much of company law is geared to the protection of the interests of investors in companies other themes are discernible. For example, incorporation has been viewed as a privilege, or concession, one which gave rise to correlated obligations on the part of those involved in corporate enterprise.[95] In recent years commentators have emphasised the idea of the social responsibility of the corporation, and debate has focused on the question of the extent to which directors of a company should consider the interests of groups such as employees, consumers and the local community in the area in which the company carries on its operations.[96] Corporate managements promote schemes to protect the environment or to increase employment opportunities, although such activities may result from a feeling that they will promote good public relations as often as from a feeling of responsibility to society. Indeed, it is possible for company law to impose limits on the right of corporate managements to work for the general good.[97]

In practice, directors of companies are rarely required to consider the interests of persons other than shareholders. Directors have a statutory duty to consider the interests of employees,[98] and judges have recently recognised a duty to consider the interests of creditors where the company is insolvent,[99] or even doubtfully solvent.[100] These duties are of limited value to those whom they are meant to benefit: the duty to consider the interests of employees is enforceable in the same way as are the other duties imposed on directors, and is therefore subject to the rule in *Foss* v *Harbottle*. The duty to creditors will in any event be enforced as part of a liquidation.

The Code also suggests that directors should consider the interests of employees and creditors of the company in advising shareholders,[101] however, the provisions of the Code are generally geared to the protection of investors. The Code aims to ensure that the decision as to whether a take-over will succeed or not is taken by the target shareholders, a group which will have no further interest in the company's affairs if it decides to accept the offer — unless the consideration offered consists of shares in the offeror. This could be an argument in favour of a requirement that all offerors offer a consideration in shares rather than cash, to tie target company shareholders to the interests of the continuing entity to ensure that their decisions reflected the interests of that entity rather than their own personal interests. However, this suggestion conflicts with views that shareholders should be allowed to sell out so they are not forced to continue in an enterprise different from that in which they invested.[102] Moreover, a requirement that target shareholders remain involved in the combined entity could reduce the allocative efficiency of the market for corporate control.

Take-overs and mergers are subject to scrutiny by the Monopolies and Mergers Commission under the provisions of the Fair Trading Act 1973, and the Commission is able to block transactions which will operate 'against the public interest.'[103] The Director

95 See, for example: Stokes, 'Company Law and Legal Theory' in Twining (ed), *Legal Theory and Common Law* (Oxford: Basil Blackwell 1986), p. 162.

96 See, for example: Hopt and Teubner (eds), *Corporate Governance and Directors' Liabilities* (Berlin: Walter de Gruyter 1985).

97 See, for example: *Rosemary Simmons* v *UDT* [1986] 1 WLR 1440.

98 See section 309 of the Companies Act 1985.

99 *West Mercia Soafetywear* v *Dodd* [1988] BCLC 250.

100 *Brady* v *Brady* (1987) 3 BCC 535, 552 (obiter) (CA), reversed [1988] 2 WLR 1308.

101 See General Principle 9.

102 See, for example: Bradley and Rosenzweig 'Defensive Stock Repurchases and the Appraisal Remedy' 96 Yale L. J. 322 (1986) p. 331.

103 Sections 69(1)(b), 69(4) and 84 of the Fair Trading Act 1973; and see Craig, 'The Monopolies and Mergers Commission: Competition and Administrative Rationality' in Baldwin and McCrudden (eds), *Regulation and Public Law* (London: Weidenfeld and Nicolson 1987); Fairburn, 'The Evolution of Merger Policy in Britain' in Fairburn and Kay (eds), *Mergers and Mergers Policy* note 2 above.

General of Fair Trading has said that 'in assessing the public interest, my primary concern (though not an exclusive concern) has been whether competition would be adversely affected.'[104]

It seems that when considering whether to recommend to the Secretary of State that a proposed merger be referred to the Monopolies and Mergers Commission for consideration the Director General of Fair Trading assesses the public interest on the basis of whether competition could be affected adversely. When the Monopolies and Mergers Commission considers proposed mergers many other considerations are included in the question of whether the merger will operate contrary to the public interest.

During 1986, of the fourteen reports of the Monopolies and Mergers Commission which were published and presented to Parliament by the Secretary of State for Trade and Industry, six dealt with mergers.[105] The Monopolies and Mergers Commission decided that two out of the six proposed mergers might be expected to operate against the public interest.[106] In one of these cases the merger was allowed to proceed, subject to undertakings,[107] in the other case the merger was not allowed to proceed.[108]

The reports on these proposed mergers reveal that the Monopolies and Mergers Commission took various factors into account. For example, in the BET report, the Monopolies and Mergers Commission refers to effects on efficiency,[109] on research and development and product development,[110] on employment,[111] on safety and training,[112] and on imports.[113] In the Elders report, in addition to competition considerations,[114] the Monopolies and Mergers Commission took account of the potential effect on employment[115] and of the question of whether Elders might raid the surplus in the Allied-Lyons pension fund.[116] Other considerations involved the likelihood of the reverse situation being allowed in Australia.[117] In the report, the Monopolies and Mergers Commission considered the general question of highly leveraged bids,[118] and recommended that the Bank of England and the Stock Exchange should consider whether new controls were desirable to deal with such bids.[119]

In another case, the Monopolies and Mergers Commission considered a predator's financial position, and the effects that this might have on the target or the region in which the target operated. 'A company's activities might be subject to such risks that it would be contrary to the public interest for it to expand its business by acquisition because by doing so it would either increase the degree of that risk or widen the area of activity affected by the

---

104 *Annual Report of the Director General of Fair Trading for the period January to December 1985 to the Secretary of State for Trade and Industry* HC 403 (1986). See also *DTI — the department for Enterprise* CM 278 (1988) at para 2.10, indicating that in the future decisions as to whether to refer mergers, and the assessment of mergers by the Monopolies and Mergers Commission, will continue to be based mainly on the likely effect of the merger on competition, although other issues may occasionally be considered.
105 *British Telecommunications PLC and Mitel Corporation* Cmnd 9715 (1986) ('BT'); *BET Public Limited Company and SGB Group plc* Cmnd 9795 (1986) ('BET'); *The General Electric Company plc and The Plessey Company PLC* Cmnd 9867 (1986) ('GEC'); *Elders IXL Ltd and Allied-Lyons PLC* Cmnd 9892 (1986) ('Elders'); *Norton Opax PLC and McCorquodale PLC* Cmnd 9904 (1986) ('Norton'); *The Peninsular and Oriental Steam Navigation Company and European Ferries Group PLC* CM 31 (1986) ('P&O').
106 BT and GEC, note 105 above.
107 BT, note 105 above, at para 10.77.
108 GEC, note 105 above.
109 At para 7.38.
110 At para 7.40.
111 At para 7.41.
112 At para 7.43.
113 At para 7.45.
114 At paras 8.5 to 8.9.
115 At paras 8.10 to 8.12.
116 At para 8.13.
117 At paras 8.14–8.17.
118 At paras 8.50–8.54.
119 At para 8.54.

risk.'[120] In another report the Commission decided that a merger would be contrary to the public interest because the predator's past record showed that it appeared 'to have bought and sold subsidiaries with regard mainly to the immediate financial interests of the group.'[121] In yet another report the Commission considered the implications of foreign ownership of a British company.[122]

It is apparent that, despite the rhetoric of merger control, which emphasises competition, regulators are prepared to consider other factors, and to prevent take-overs on the basis of other factors. The DTI has recently identified factors which will be taken into account in determining the effect of a merger on competition, although it has said that: '[i]t is not possible to set out rules of thumb which can be staightforwardly or mechanically applied to all cases'.[123] In the same report, the DTI expressed the Government's view that the effects of mergers on employment, on the regions, and on research and development spending, and the effects of highly leveraged bids and foreign take-overs are matters where there is usually no divergence between the interests of private sector decision makers.[124] It remains to be seen whether the Monopolies and Mergers Commission will ignore these matters in future.

## 5. Conclusion

Current regulation of take-overs in the United Kingdom concentrates on protection of shareholders in target companies, and on restriction of the adverse effects of take-overs on competition. Both systems of regulation are costly, involving the institutional costs of running the system and the transaction costs imposed on participants in take-overs. For this reason, it is important that regulation achieves its aims.

Three criticisms of the current system may be made: (1) greater legal protection should be provided to target company shareholders; (2) the interests of predator company shareholders should be recognised and protected; and (3) protection of the public interest should operate in a less haphazard and more predictable manner. In general, regulation of the way in which take-overs are effected, and regulation of public interest issues involved in take-overs should be co-ordinated in a single scheme, rather than by two regulatory bodies. It is not clear that issues involving the interests of target and predator company shareholders are sufficiently distinct from issues involving other interests to justify separate systems.

120 *Lonrho Limited and Scottish and Universal Investments Limited and House of Fraser Limited.* HC 261 (1979) at para 8.27.
121 *Amalgamated Industrials Limited and Herbert Morris Limited.* HC 434 (1976) at para 127.
122 *Enserch Corporation and Davy Corporation Limited.* Cmnd 8360 (1981) at paras 9.16–9.24.
123 *Mergers Policy* note 3 above, at para 2.15.
124 At paras 2.20–2.28.