Erik Berglöf and Mike Burkart

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European Takeover Regulation *

Erik Berglof and Mike Burkart

SITE and Department of Finance, Stockholm School of Economics and CEPR

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Summary

In its quest for more corporate restructuring and a single market for capital, the European Commission is pushing for Europe-wide takeover regulation. Previous attempts have failed largely due to differences in corporate governance arrangements across Member States. This article provides a framework for evaluating the effects of takeover regulation. We apply this framework to some specific proposals in the European debate and show that their impact often depends critically on the structure of ownership and control. In particular, two of the most discussed rules, the strict mandatory bid rule and the break-through rule, have no impact when ownership is dispersed. Also, the proposed break-trough rule would only affect firms with dual-class shares but not firms that use other control instruments. Moreover, the two rules would effectively counteract each other, the break-through rule promoting takeovers and the mandatory bid rule impeding them. Introducing a strict mandatory bid rule alone, as the Commission proposed, would slow down restructuring. We argue that while increased contestability of control is desirable hostile takeovers are a rather blunt instrument for achieving this. The market for corporate control is only one of many corporate governance mechanisms to be honed in order to promote corporate restructuring in Europe.

1.Introduction

After decades of failed attempts and the stinging defeat in the European Parliament in 2001 the Commission remains committed to the idea of a pan-European takeover directive. The Commission argues that more takeovers will lead to more restructuring, and Europe badly needs more restructuring if it wants to catch up with, and overtake, the United States as set out in the Lisbon declaration. In 2002 a High Level Group of Company Law Experts appointed by the European Commission and under the leadership of the Dutch Law Professor Jaap Winter presented two reports; a first report on European takeover regulation and a final report on a modern regulatory framework for company law in the EU. In the analysis of the Winter Group the core problem is the entrenched ownership and control structures in most Member States and the asymmetry of rules regulating takeovers. Consequently, the Group argues for more contestability of controlling owners and a level-playing field in takeover markets.

To achieve contestability and a level-playing field the Group proposed a set of measures intended to limit defensive measures after a bid has been made for a company, most of them part of the failed draft directive from 2001. In particular, the proposal required that shareholders, not management, approve any defensive measures once a bid is announced, and that a bidder must pay all shareholders the same price (the mandatory bid rule). But the Group went further in proposing that differentiation of votes, one of the most common methods for separating ownership and control, should be voided in votes on takeover bids. Moreover, a bidder once he had achieved a qualified majority of equity could undo any statutory defenses, including any differentiation of votes (the so-called break-through rule). The break-through rule was later dropped from the draft directive after intense criticism from several Member States and controlling owners affected by the rule, but together with the mandatory bid rule the break-through rule illustrates some fundamental principles in takeover regulation.

Given their far-reaching nature and broad impact - the break-through rule, for example, alone would undermine the controlling position of the leading shareholder in one out of six listed companies with dual-class shares (Bennedsen and Nielsen, 2002) – it is remarkable that the proposals from the Winter Group and the Commission are essentially void of any economic analysis. Moreover, very little reference is made to the extensive empirical and theoretical literature on takeovers and corporate governance in economics. This article wants to provide the missing analysis. We provide a conceptual framework to analyze the interrelationship between the market for corporate control and corporate governance. The framework also allows us to understand how the effects of specific pieces of regulation depend on the context, in particular on existing structures of ownership and control. Ultimately, we ask the question what type of takeover regulation and corporate governance reform do we need in Europe to achieve more restructuring.

Takeover regulation determines the rules of the game before and after a bid for control over a firm has been placed. These rules influence the distribution of gains from takeovers between the bidding firm and the target firm, and between controlling and minority shareholders in the target firm. The more of the surplus that is allocated to the bidding firm, the stronger are the incentives to make a bid. And the more of the surplus the minority shareholders appropriate, the less incentives there are to hold controlling blocks. Any body of takeover regulations, such as the Commission's draft directive or the UK City Code contain a substantial number of provisions, most of them generally accepted. In this paper we focus on three sets of measures where there is still controversy: specific defensive measures, mandatory bid rules, and break-through rules. They illustrate the basic economic principles of takeover regulation, and they are central to the debate on takeover regulation and mobility of corporate control in Europe.

Our analysis shows that the effects of individual pieces of takeover regulation often depend critically on the ownership and control structure in the target firm. For example, neither the mandatory bid rule nor the break-through rule have any impact when a firm's shares are widely dispersed. More importantly, the specific break-through rule proposed by the Winter Group only affects dual class shares and not other control instruments. Moreover, and less well understood, when there is a controlling minority shareholder, the mandatory bid rule makes it more costly to take over a firm and the break-through rule makes it cheaper. In other words, the two rules have opposite effects: one encourages takeover activity and the other discourages such activity.

The Commission's draft directive, without the break-through rule but with a strict mandatory bid rule, further entrenches existing control structures and reduces contestability, contrary to its intentions. We show that a strict mandatory bid rule does eliminate some value reducing takeover bids, but at the cost of also getting rid of some value-increasing bids. In particular, the mandatory bid rule effectively shuts down the trade in controlling blocks, the dominant form for control transfer in most of Europe. While the mandatory bid rule in the draft directive is unambiguously detrimental to promoting restructuring, it may or may not be good for minority protection: The rule increases the compensation to minority shareholders in case of a successful takeover, but it decreases the likelihood of a takeover. Which effect dominates is ultimately an empirical issue.

Introducing the break-through rule effectively undermines the mandatory bid rule, opening up block trades and making possible value-reducing and value-increasing bids previously prevented by the latter rule. The break-through rule alone would unambiguously promote takeover activity and contestability, essentially by lowering the cost of a successful bid. However, since the rule fundamentally alters the initial contracts of the controlling owners, it represents a massive ex post government intervention, introducing uncertainty into the fundamental property rights regime with large potential ex ante costs for entrepreneurship and the willingness of controlling owners to exercise corporate governance. These costs have to be weighed against potential benefits.

So we find that while increased contestability is a worthwhile goal for European takeover regulation, its exact meaning must be understood in the context of existing ownership and control arrangements in Europe. Contestability is clearly desirable in that it disciplines controlling owners and managers, and it raises the potential that more efficient owners and managers may come in control. But contestability is neither a sufficient nor a necessary condition for good corporate governance at the level of the individual firm. There are many examples of successful family firms where control is not and has never been contestable. In the system as a whole contestability must be weighed against any negative effects it might have on incentives for entrepreneurial activity and monitoring by large controlling shareholders, and on the protection of minority investors.

Our analysis suggests that relying solely on hostile takeovers to increase contestability is not recommendable. Hostile takeovers do not guarantee that the existing corporate resources are managed more efficiently. While they can mitigate agency problems between managers and shareholders, hostile takeovers are naturally subject to the same agency problems as any corporate decision. Hostile takeovers are also only one of many mechanisms in the larger corporate governance system. Like other takeovers, these mechanisms have their costs and benefits. And since the various corporate governance mechanisms are complementary and highly interconnected, changes in one component almost always entail some costs. The challenge in corporate governance is to balance the costs and benefits of these different mechanisms in terms of how they affect the larger system.

Creating a level-playing field in the market for corporate control is a noble objective. But as our analysis clearly demonstrates, a level-playing field is not the same as harmonization of takeover regulation. Specific rules have very different effects in different environments. In particular, the effects of the mandatory bid rule and a break-through rule of the type proposed by the Winter

Group depend on the ownership and control structure in the target firm. Given the considerable variation in ownership and control within the European Union, most notably between the UK and the rest of Europe, the mandatory bid rule, for instance, impedes the takeover of a typical German firm with its controlling owners, but not that of a typical UK firm with its dispersed ownership.

The paper starts by examining the variation in the level and type of takeover activity within Europe and the various "barriers" potentially explaining this variation. While there are several contributing factors, we argue that the prevalence of controlling blocks is the single most important "barrier" limiting hostile takeovers. Using recently accumulated data we provide a more detailed account of the patterns of ownership and control in European firms. In the next section (Section 3) we discuss the principles of takeover regulation, and Section 4 describes national takeover regulation and attempts to regulate takeovers at the EU-level. Takeover regulation is closely linked to corporate governance, and in Section 5 we discuss the interrelationship. Section 6 provides an economic analysis of defensive measures, mandatory bid rule, and break-through rule. In Section 7 we discuss our findings and conclude with some policy recommendations in Section 8.

2.Ownership and Control in Corporate Europe

The overriding concern of the Commission is to promote restructuring of European industry. Even though there are large fluctuations over time in individual countries, the general perception is that, at least during the 1970s and the 1980s, the United States has been more successful in restructuring its industry (Holmström and Kaplan, 2001). A considerable share of this restructuring was achieved through hostile takeovers, and even when transactions were negotiated the potential of a hostile bid played an important role. Within Europe hostile takeovers were primarily confined to the United Kingdom. Hostile takeovers in the sense of tender offers launched in the market have been very rare in Continental Europe, at least until recently. For instance, in 1989 there were only four hostile takeovers in all the rest of the EU15, compared to 36 in the UK (Becht et al., 2002). The turnover of control was also much higher in the UK with the number of friendly transactions alone clearly outnumbering those on the European Continent.

During the 1990s the picture changed somewhat with a large increase in the total number of control transactions, but the number of hostile takeovers remained negligible until the last few years of the 1990s. In fact, in 1999 the number of hostile takeovers was the same in the UK and the rest of the EU15. However, seen in relation to the size of the economy, hostile takeovers played a much more important role in the UK than in the rest of the European Union (Becht et al., 2002). However, there was some variation among the rest of the countries. In particular, Sweden had a total of about 250 takeovers during the period 1990-2001, which corresponds to 9 per cent of the number of listed firms or about the same number of friendly control transactions per listed firm (Berglöf et al., 2003). In Germany with a much larger number of listed firms and an even larger economy the corresponding figure was about 100.

Interestingly, in the US overall restructuring activity remained about the same despite a drop in the level of hostile takeovers during the 1990s, with a brief resurgence in the middle of the decade. This decline in hostile control transactions can be largely attributed to the increasingly management-friendly judges in key US states, such as Delaware, where most large companies are incorporated (Holmström and Kaplan, 2001). A series of court decisions came out in favor of managerial defenses and of a broad interpretation of the business judgment rule giving management discretion over key strategic decisions.

In interpreting these numbers it is important to remember that hostile and friendly may be harder to differentiate than the names may suggest. The distinction is normally based on whether the board in the target firm supported the bid. But the vote of the board could be influenced by many things, including the prospects of the bid eventually succeeding. In fact, many seemingly friendly transactions have hostile components. Jenkinson and Ljungqvist (2002) document a considerable degree of hostility in a number of control transactions in Germany that fall outside of the official classification of hostile takeovers.

Control blocks are also traded without formal takeovers taking place. Köke (2000) examines a larger sample of almost 1000 German firms (large listed, medium sized and/or non-listed firms) over the years 1987 to 1994. He finds that there is significant trading in large share blocks, and that the vast majority of these transactions involve controlling blocks. On average, 7 per cent of control changes per year in Germany compared to 6.3 per cent in Belgium, to 6.7 per cent in the US, and to 9 per cent in the UK. Such changes in control are typically followed by increased management and board turnover, more asset restructuring and layoffs.

In addition, there is an active "private" market for corporate assets and corporate control outside the public exchanges (Wymeersch, 1998). In terms of number of transactions, about half the number of transactions taking place worldwide involve European companies. These transactions mostly involve privately owned firms, including subsidiaries and divisions of listed corporations. Both in terms of numbers of transactions and of turnover, this market exceeds the markets for public takeover bids.

2.1 Barriers to takeover

A number of features of the Continental European (or non-UK) economies have been put forward as explaining these differences in the level of takeover activity. These so-called takeover barriers are functionally similar to takeover defenses in that they both help to entrench target management (Ferrarini, 2000). Takeover barriers are common in Continental Europe, while takeover defenses are widely used in the US. Takeover defenses may be divided into pre-bid and post-bid defenses.

Takeover barriers may be further broken down into structural and technical barriers. Structural barriers are part of the institutional setting, such as influence of banks (Hausbank), ownership structure, and size of the equity market. Technical barriers are part of each individual firm's governance structure laid down in the corporate charter and allocate the powers among its constituencies (shareholders, management, workers, etc.). Examples of such common technical barriers that are specifically aimed at frustrating hostile bids are restrictions on the transferability of shares and voting restrictions. Dual-class shares, pyramidal groups, and cross-shareholdings are devices to separate ownership and control, thereby providing also protection against unfriendly acquisition attempts.

We will focus our discussion on ownership and control as a barrier to takeovers, but let us first briefly discuss the other suggested structural barriers. All of these barriers are, more or less, associated with Germany, but not only with that country. The case for co-determination and close bank-firm relationships as barriers to takeovers rests on the argument that employees and banks naturally form alliances with incumbent management or controlling owners. This, in turn, hinges on the distribution of gains from takeovers, the assumption being that employees and creditors would somehow lose out (compare the arguments of Pagano and Volpin (2001) and Cespa and Cestone (2002)). Empirical evidence from the US suggests that wage cuts explain only a small fraction of the takeover premium (for a survey of the evidence, see Burkart (1999)). And there is little evidence that creditors would suffer substantial losses in takeovers.[1]

[1] A close relationship to a bank is not always a guarantee against a hostile bid. Franks and Mayer (1998) show that in all the three cases of post-WWII hostile takeovers in Germany did the target company's house bank exert considerable influence over the outcome through the chairmanship of the supervisory board (this is probably also true for the many of the cases of potential hostile bids that never materialized).

As for the size of equity markets as a structural barrier it is undoubtedly true that only firms listed on exchanges can be subjected to hostile bids. If, as in for example Germany and Italy, only a small share of the total number of the country's firms are listed, then this constitutes a limit to contestability of control in that country's industry. An obvious way to foster contestability is to encourage public listings of firms. Takeover regulation indirectly affects the incentives to list through its impact on the distribution of gains from a future takeover bid. Obviously, takeover rules that create uncertainty about fundamental property rights of the controlling owner also discourage listings.

2.2. Ownership and Control

Ownership and control in Corporate Europe is put forth as a serious obstacle to hostile takeovers and possibly to restructuring more generally. Recent comparable data on ownership and control collected within the European Corporate Governance Network (summarized in a recent volume edited by Barca and Becht, 2001) allow us to form a better view of the extent of entrenchment.

Corporate Europe spans a wide range of ownership and control structures, ranging from closely-held family firms to firms with widely dispersed shareholdings, but as in much of the rest of the world most companies have a large controlling shareholder (Barca and Becht, 2001; and La Porta et al., 1999). Corporations in the UK (and the US) stand out as having more widely dispersed ownership than the rest of the world, but there is also considerable variation in ownership concentration within Continental Europe. In half of listed non-financial firms in Austria, Belgium, Germany, and Italy a single shareholder controls more than 50 per cent of the votes (compared to 9.9 per cent in the UK). In Dutch, Spanish, and Swedish firms the median blockholder holds 43.5, 34.5, and 34.9 per cent, respectively.

Figure 1 shows the distribution of firms by the size of the largest voting block in some selected countries. (When the dotted line is far below (above) the diagonal line, there are few (many) firms with large controlling blocks.) These distributions suggest a broad spectrum of ownership and control structures with large blockholders on the European Continent. In some cases the owner/manager controls a majority of the votes, and in others the largest blockholder has opted for a blocking minority stake. Also the observed clustering at certain levels of voting power illustrates the impact of laws and regulation. For instance, the dotted line for Germany exhibits steps at 25 per cent (blocking minority), 50 per cent (simple majority) and 75 per cent (common qualified majority).

Insert FIGURE 1

But the amount of votes controlled by the largest shareholder is but one dimension shaping the governance structure in a firm. Other relevant aspects include how the large shareholder secures control, how the remaining voting and return rights are held, and the relationship between the controlling shareholder and top management. Moreover, it is interesting to know the identity of the controlling owners.

Most countries allow at least one of the three principal mechanisms for separating control from ownership (of cash flow rights): (1) shares with differentiated voting power; (2) pyramiding where control is exercised through several layers of companies; and (3) cross-holdings where a firm directly or indirectly controls its own shares. Pyramiding is the most effective device for separating ownership and control in that it is multiplicative (rather than additive as for vote differentiation). Assuming that 50 per cent is necessary for controlling a firm, pyramiding by adding one layer allows control in the firm at the bottom with a mere 25 per cent of the equity (.5 x .5 per cent). The multiplier between capital and votes in the pyramid is $1/(1/2)^n$ where n denotes the number of levels in the pyramid. In other words, the vote multiplier is 4.

These control enhancing mechanisms are sometimes used together. By combining shares with different voting power and pyramiding, a controlling owner can maintain control over the company at the bottom of the pyramid with even smaller shares of its cash flow rights. Bennedsen and Nielsen (2002) have calculated that one-fifth of firms listed on European exchanges make use of differentiated votes, with the practice being particularly widespread in Scandinavia. Faccio and Lang (2002) report that pyramids are used by 19 per cent of listed European firms that have a controlling shareholder at the 20 per cent level. Pyramids are most prevalent in Norway (33.9 per cent) and least prevalent in Finland (7.46 per cent). Crossholdings are also used in Germany but are marginal in other countries. The ownership and control structure where the owner/manager has sold out the majority of shares to dispersed shareholders but retains control is denoted a *controlling minority shareholder*. The possibility to control firms with limited equity stakes is at the heart of much of the corporate governance debate in Continental Europe.

The voting and return rights not controlled by the largest shareholder can be held in several ways. The shares could be widely dispersed, but *several* large shareholders with substantial blocks of shares are also common (Barca and Becht, 2001). For a sample of 5232 European companies, Faccio and Lang (2002) find that 39 per cent of firms have at least two shareholders owning 10 per cent or more of votes, and 16 per cent have three shareholders, each owning at least 10 per cent of the votes. In order to evaluate the role of additional large blockholdings we need to know more about the relationship between the largest blockholder and other blockholders. A controlling minority shareholder could have sold a large block to a friendly investor. Alternatively, an investor could have accumulated a substantial block of previously dispersed shares more or less against the desire of the controlling owner/manager. Whether the other large blockholders are essentially friendly or hostile is going to shape the dynamics of corporate governance in the firm.

The identity of the controlling owner is also likely to shape the nature and dynamics of corporate governance. Recent empirical research has tried to penetrate these complex, often multi-layered, ownership and control arrangements in search of ultimate controlling owners (LaPorta et al., 1999; and Faccio and Lang, 2002). Most publicly traded firms in Europe are either widely held or family controlled. There is, however, a marked difference in the ranking of these two categories across Europe. In Continental Europe, as in most other countries of the world, family controlled firms are in the majority. By contrast, widely held firms clearly outnumber family controlled firms in the UK and Ireland. To understand the predominance of family control we need to answer the question why, in the first place, founders and investors retain large controlling stakes in firms. After all, abstaining from diversification is costly and controlling blocks are typically rather illiquid. Individuals and organizations forgo diversification benefits in order to induce those in charge of running the company to take decisions that are in the interests of the suppliers of finance (shareholders). As we will illustrate below, ownership of large blocks - whether by manager or by outside blockholder – is, however, not unequivocally positive but comes with costs and benefits.

3. Promoting Takeover versus Protecting Minority Interests

Takeover regulation - whether implicitly or explicitly - influences how the takeover gains are shared between the bidding and the target firm, and thereby affects the incentives to undertake respectively accept a bid. Since granting one side, say the bidder, a larger fraction of the takeover gains necessarily implies that target shareholders receive less of the surplus, any takeover regulation has to confront the trade-off between promoting the mobility of corporate control and protecting small (minority) shareholders. To illustrate this general point we briefly review the well-known "free-rider problem", identified by Grossman and Hart (1980), which is central to the understanding of both how the tender offer process functions and how regulation affects (the incidence of) takeovers. Thereafter, we turn our attention to the current takeover regulations in Europe. As we will argue the impact, relevance, and desirability of a specific takeover rule crucially depend on the corporate governance system to which it is applied.

In their seminal paper, Grossman and Hart (1980) show that managers who are either inefficient or pursue self-serving actions need not be vulnerable to a takeover bid, even though – or more accurately precisely because - ownership is widely dispersed. Each small shareholder rightly presumes that his decision to tender has a negligible impact on the tender offer outcome. Accordingly, a shareholder only finds it in his interest to tender if the offered bid price at least matches the post-takeover share value. Otherwise, he prefers to "free-ride". By not tendering, he captures the whole value improvement that the bidder can generate. As all small shareholders behave in the same manner the bidder makes zero profit on the shares acquired in the tender offer. Or putting it differently, a success of a value-increasing bid is a public good for the target shareholders, but each individual shareholder has an incentive not to tender in order to "free-ride". As a result, there are too few takeover attempts, and if a takeover occurs, most of the gains go to target shareholders.[2] This latter implication of the "free-rider" result is confirmed by numerous empirical studies (Burkart 1999).

The literature has suggested two ways to mitigate the "free-rider" problem, both of relevance in the context of (European) takeover legislation. Grossman and Hart (1980) propose to allow bidders to dilute the value of the post-takeover minority shares. Excluding minority shareholders from part of the takeover gains creates a wedge between the post-takeover share value to the bidder and that to the minority shareholders. This implies that shareholders are willing to tender already at a price at which the bidder still makes a profit.[3] Note also that the bid price does not depend upon whether or not restricted bids are banned. With or without the mandatory bid rule, the bidder simply offers a

[2] Other (complementary) reasons why a bidder may fail to make a profit are competition by other bidders and defensive actions by the incumbent management.

[3] Another way to overcome the "free-rider problem" is to grant a successful bidder a squeeze-out right, i.e., the right to compel remaining minority shareholders to sell their shares (Yarrow 1985). The squeeze-out right affects the tendering decision in a similar manner as the dilution of minority shareholder rights. When an offer conditional upon acceptance of the freeze-out fraction succeeds, any remaining minority shareholder will be forced to sell his shares on the terms of the original offer. Hence, he may as well accept the original offer. The Commission's latest draft directive (October 2002) introduces the squeeze-out right with a threshold of between 90 to 95 per cent of the equity capital.

price equal to the post-takeover minority share value, and the shareholders neither gain nor lose from tendering their shares (given that the takeover succeeds).[4]

The above argument illustrates how (takeover) regulation can affect the distribution of takeover gains and thereby the bidder's incentives to undertake a bid as well as the target shareholders' incentive to accept it. It also makes the conflict between promoting takeovers and protecting minority interests very transparent.[5] Strong (minority) shareholder protection discourages bidders because their profits are eroded by the target shareholders' "free-rider" behaviour. Hence, a takeover mechanism that fulfills its role of creating wealth by exploiting synergies and of disciplining management relies on granting bidders benefits that do not accrue to other shareholders on a pro-rata basis. Such private benefits conflict with equal treatment and protection of minority shareholders. Consequently, a functioning market for corporate control cannot be pursued separately from the protection of minority shareholders, but one goal has to be traded-off against the other. To the extent that shareholder protection is tantamount to increasing the target shareholders' share of the takeover gains it diminishes the bidder's private benefits, thereby resulting in a less active market for corporate control.

This trade-off also implies that maximum minority protection is not in the target shareholders' best interest. Less shareholder protection improves the bidder's profit prospect and thereby increases the likelihood that the shareholders collect a takeover premium. From their perspective, the optimal amount of protection maximizes the expected takeover premium, i.e., strikes a balance between a higher bid price in the event of a takeover and a lower probability of a takeover.

A closely related point is that minority protection aimed at restricting the dilution of minority shares does not serve as a screening device.[6] As shown in "Box I: Bidder Screening and Minority Protection", better minority protection does not frustrate those bids where the bidder is the primary recipient of the takeover gains without discouraging even more those bids where the gains are more

[4] The argument implicitly assumes that the takeover is value increasing with a post-takeover minority share value that exceeds the current share value under the incumbent management. In a more general single bidder setting where the takeover may or may not be value increasing, the mandatory bid rule can prevent that minority shareholders incur a loss relative to the current share value. However, the mandatory bid rule never simultaneously secures a bid premium and provides effective protection: Either the status quo (current share value) determines the bid price in which case the takeover premium is zero, or the post-takeover minority share value determines the bid price in which case the mandatory bid rule has no impact (Burkart 1999).

[5] Like other takeover regulations such as the UK City Code and the federal US regulation, both the Winter Report and the various (failed) drafts for a takeover directive endorse protection of (minority) shareholder interests and a functioning market for corporate control as main regulatory objectives.

[6] As shown below in Box II, rules that impose a minimum price in a control transaction, such as the mandatory bid rule, can to some extent screen between bidders.

evenly shared.[7] Due to the free-rider behaviour, better protection raises the bid price for "good" bidders (who bring large efficiency gains) and "bad" bidders (who extract large private benefits). Since the profit margin of good bidders is typically smaller than that of bad bidders, better protection is more likely to discourage good bidders.

Insert BOX I

A second solution to the free-rider problem is the acquisition of a stake prior to the tender offer (Shleifer and Vishny, 1986). If the pre-takeover price of the stake is relatively low, the bidder earns a profit on this stake, making the takeover profitable, even if all tendered shares are acquired at the full post-takeover value. Indeed, pre-takeover holdings are found to have a positive impact on bidder gains and on the success probability of takeovers (Burkart, 1999).

The ease and extent to which a bidder can accumulate an initial stake through secret open market purchases depend on the market depth and the disclosure requirement. Once a bidder has to disclose his identity (and holdings), further open market purchases become increasingly less attractive. Thus, by limiting the numbers of shares that a bidder can acquire before submitting a public tender offer, disclosure requirements affect the division of takeover gains. When choosing a disclosure threshold, a regulator faces again the trade-off between promoting takeovers and protecting minority interests. Lax disclosure standards allocate a larger share of the takeover gains to the bidder, thereby promoting an active takeover market. This, however, comes at the expense of those shareholders that sold their shares prior to the bid, thereby forgoing the takeover premium.

Instead of accumulating an initial stake through open market purchases, the bidder may seek out a large shareholder and negotiate a block sale. Even though the bidder has to surrender part of the subsequent takeover gains on the block to the incumbent blockholder, a block trade may be more profitable than accumulating a stake through secret open market purchases. Thus, the existence of large shareholdings facilitates takeovers relative to a firm with dispersed ownership. The blockholder's ability to promote a takeover by either selling or tendering his shares also allows him to impede it by retaining his shares. Both increase with the block size, or more precisely with the associated number of votes, and an incumbent shareholder with a majority of the votes can unilaterally accept or reject a takeover attempt. This latter possibility has been a main concern in

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[7] This reasoning implicitly assumes that there is no competition among bidders. When multiple bidders compete for a target, bids and counterbids typically drive the price up beyond the level imposed by minority protection, making the latter a non-binding constraint.

debate on EU takeover regulation in those cases where a majority of votes is controlled with a much smaller proportion of the equity capital.

4. Takeover Regulation in Europe

This section describes the regulatory framework governing control transfers at the level of Member States and provides a brief account of the attempts to regulate takeovers at the level of the EU, including the recommendations of the Winter Group and the Commission’s draft directive (October 2002).

4.1. National Regulation

Following several highly publicized takeovers the UK introduced in 1968 its self-regulatory City Code on Takeovers and Mergers, which has since been revised and expanded several times. The purpose of the code is to ensure fair and equal treatment of all shareholders in connection with corporate takeovers and to provide an orderly framework within which takeovers are conducted. To this end, the code regulates the actions of bidders prior to the announcement of the bid, the content of the information issued to shareholders by bidder and target companies, and the defensive measures available to the target companies.

With respect to the two most debated aspects of takeover regulation, the mandatory bid rule and the scope for defensive actions, the City Code adopts strict versions. First, the code obliges a party who reaches through purchases the threshold of 30 per cent of the voting rights in a listed company to make an offer to buy the remaining shares. The price in the mandatory offer may be no less than any price paid within the preceding 12 months. Second, the code prohibits managers from taking any defensive action without shareholder consent once an offer is made or seems imminent. It further forbids explicitly the issue of retained shares and options, the sale or acquisition of assets of a material amount, and entering into contracts otherwise than in the ordinary course of business.

Until the 1980s takeover regulation remained essentially a UK (and US) phenomenon. In most Continental European countries takeover bids were still so rare that special regulations were long thought to be unnecessary. Acquisitions traditionally were based on negotiations between the acquirer and the target company's management, and transactions took place outside the public exchanges. During the latter part of the 1980s, however, activity in European stock markets increased dramatically, as did the number of takeover bids targeted directly at the shareholders – in some cases with no prior negotiations at all and in others after negotiations had proved unsuccessful. Cross-border corporate takeovers also increased as wrestling control of companies in other countries through public takeover bids became more accepted.

In response to these developments most Member States first adopted some form of self-regulation and later opted for binding legal rules, but some countries have maintained self-regulatory regimes see Table 1). These national regulations are strongly influenced by the British example. In fact, the City Code has served as the standard in many areas such as information and disclosure, conduct during the offer, or competing offers (Hopt, 2002). This does, however, not apply to the mandatory bid rule and defensive measure where some Member States opted for different provisions.

Almost all Member States have adopted some form of mandatory bid rule, either through self-regulation or by law, but the design of rules differs across jurisdictions. The UK has the most extreme form of mandatory bid rule that effectively prevents the acquisition of a controlling block at a premium. Continental European mandatory bid rules are typically less demanding, allowing either for a price discount or restricting the quantity of the outstanding shares that the rival is obliged to acquire (Ferrarini, 2002). The level of blockholding triggering a mandatory bid also differs across Member States (see Table 1). Defensive measures by incumbents have also been regulated in most Member States. In general, boards may only take such measures after approval from shareholders. In Germany, however, shareholders can approve measures in advance, in effect giving the supervisory board considerable leeway in responding to takeover bids.

To summarise, national regulations within the EU have gradually converged to the UK rules, and today variation across Member States is limited. Though there remain some differences as to the mandatory bid rule and the scope of the board to take defensive action, most notably in Germany. Overall investor protection has probably been strengthened through the introduction of mandatory bid rules, at the expense of mobility on the market for control. But the increasing emphasis on shareholder approval of defensive measures has moderated this shift. Thus, there is little evidence of a “race-to-the-bottom” in the sense of no regulation.

This picture contrasts sharply with that of the United States which has a dual regime with both federal and state laws. The principal federal legislation (The Williams Act) is aimed at procedural disclosure rules in the tender offer process. The Williams Act does not interfere with the power of a firm to resist a takeover bid under its corporate charter. But contrary to the EU, the US has a single standard on the accountability of a target firms' board comparable to the well-established business judgment rule, fiduciary duties relatively homogeneously defined in the US. (Hopt, 2002). It is worthwhile to note that US federal regulation contains no mandatory bid rule. State laws vary considerably across the US. Many states have many antitakeover statutes (Delaware has only one)[8] – Delaware is the only state that has a well-developed case law on the use of defensive tactics. Mandatory bid rules only exist in Pennsylvania and Maine.

Defensive tactics are within the business discretion of the boards of directors and are widely used.[9] In fact, most S&P 500 firms and a vast majority of those firms listed on the NYSE or Amex are covered by several anti-takeover devices, ranging from poison pills, supermajority amendments to state anti-takeover laws (Burkart, 1999). Court challenges have also become an important defensive weapon in takeover bids, and hostile takeover activity dropped substantially in the US during the 1990's (Holmström and Kaplan, 2001). The board can, however, only act as a fiduciary of the shareholders and these strong fiduciary duties are upheld by the American courts (Hopt, 2002). States, like Delaware, which have granted managers broad discretion in implementing takeover defences with reference to the so-called business judgment rule, have been more successful in attracting incorporations.

Regulatory competition has generally served the interests of incumbent management (Bebchuk et al., 2002). Despite the variation in treatment across jurisdictions, the extent of regulatory competition should not be exaggerated. For most companies the choice has in effect stood between incorporating in Delaware or the company's home state. Moreover, state courts have acted in the shadow of possible federal intervention. The recent reaction in Congress to the spectacular governance failures in companies like Enron and WorldCom with the passage of the Sarbanes-Oxley Act also illustrates the latent threat of intervention from the legislator. On several occasions, most notably in the aftermath of the Great Depression, federal authorities propelled by political populism asserted theirs powers to break up corporate governance arrangements. Prior to these interventions ownership and control structures in the United States resembled those of present-day Continental Europe.

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[8] There are five standard types of antitakeover statutes; control share acquisition statutes, fair price statutes, business combination statutes, poison pill endorsement statutes, and constituency statues (Bebchuk et al.,2002).

[9] The board can, however, only act as a fiduciary of the shareholders and these strong fiduciary duties are upheld by the American courts (Hopt, 2002).

4.2. EU Takeover Regulation

The first attempts to harmonize takeover regulation in the EU date back to the early 1970s when the European Commission appointed professor Robert Pennington to draw up a draft directive for takeover bids.[10] Like later drafts, this draft was strongly influenced by the UK City Code. The draft was discussed for a couple of years with representatives of the Member States, but interest was limited and eventually the entire project was folded. Ten years later the directive plans resurfaced and at the end of the 1980's the European Commission presented a proposal for a 13th Company Law Directive. The draft was widely criticized and interest among Member States was once again limited.

However, in January 1988 the situation changed overnight when the Italian businessman Carlo de Benedetti extended a bid for a controlling stake in the giant Belgian holding company Société Générale de Belgique, thereby starting one of Europe's most controversial takeover fights to date, involving numerous dubious defensive measures and unveiling a considerable void at the core of European takeover regulation. The battle for the company accelerated the Commission's directive plans. At the urging of the European Parliament, the Commission in January 1989 presented a completed proposal for a takeover directive. The proposal triggered an intense debate on the forms of a European Takeover Directive. Apart from strong objections against individual provisions, many argued that a directive should be limited to certain basic principles for national rules, while leaving the details to Member States to decide on. By the end of 1991 the Commission announced its intention to prepare yet another draft proposal which would take into account criticism raised.

The new proposal appeared five years later in 1996 and was amended several times, following comments from the first reading in the European Parliament, intense negotiations within the Council, and a protracted conciliation procedure with the European Parliament. The new proposal was a proposal for a "framework directive", containing general principles that Member States would be obliged to follow when drafting their national takeover codes. To silence British opposition Member States would even be permitted to implement the directive also through self-regulation. The Council had also given in to German resistance on several substantive points, but there was one area where the willingness to compromise ran into a wall – the issue of defensive

[10] See Skog (2002) for a thorough account of the history of (attempted) takeover regulation at the EU level.

measures. The common position stated that such measures could only be enacted with the approval of the general meeting after a bid is announced.[11] After extended negotiations the draft finally was rejected by the smallest possible margin – one vote.[12]

Despite this defeat the Commission remained committed to the idea of a European takeover regulation. In September 2001 the Commission set up a 'High Level Group of Company Law Experts' under the leadership of Jaap Winter with the task of providing independent advice on issues related to the harmonization of European corporate law, including rules for takeovers. In January 2002 the Winter Group presented its recommendations on takeover regulation building on the rejected directive. As guiding principles for the creation of a level-playing field the Group advocated shareholder decision-making and proportionality between risk-bearing capital and control. Applying these two principles, the Group made the following main recommendations:

(1) The price in a mandatory bid should be equal to the highest price paid by the bidder during the 6 to 12 preceding months. The mandatory bid should be made within a short period after control has been acquired. The exact definition of the 'level of control' is left for the Member States to decide.
(2) The board of the target company must obtain prior shareholder approval before taking any frustrating actions once a takeover bid has been announced.
(3) A bidder who acquires 75 per cent (or more) of the equity capital should be able to override any obstacle including voting differentiation[13] that prevents him from taking control over the firm (so called break-through rule). Furthermore, the bidder does not have to compensate the holder of shares carrying disproportionate voting rights or special control rights.
(4) Dual-class shares, voting caps, and other limitations to voting rights are to be voided in votes on defensive measures once a takeover bid has been announced.

[11] German opposition was intense throughout this process, and ultimately Germany no longer backed the common position in the Council, but was voted down 14 to 1 three times within the Council.

[12] After the conciliation process, it was for the European Parliament in plenary to vote on the matter, normally little more than a formality. During the discussion, however, it became evident that differences in opinion split both the conservative and socialist camps and that the vote would therefore be "free." In the end, Parliament rejected the conciliation compromise with the smallest possible margin of 1 vote. The defeat is all the more surprising when considering that the proposed directive was also crafted on the UK rules, making the difference between proposed directive and national regulation much smaller than during previous reform attempts. The directive failed because of the strong (German) opposition against the restrictions in the board's discretion over the use of defensive measures. The resistance was primarily based on a perceived asymmetry vis-à-vis the US, where most firms are effectively shielded from hostile takeovers.

[13] Company-specific barriers that should remain outside the scope of the break-through rule are provisions restricting the transferability of shares, contractual barriers to takeover bids and pyramid structures.

Recommendations (1) and (2) endorse the controversial provisions of the failed takeover directive, while recommendations (3) and (4) go much further. They aim at removing a controlling minority shareholder's veto power over a takeover bid. In addition, the Group recommended the introduction of the right for a majority shareholder to buy out minority shareholders (squeeze-out right), and of the right for minority shareholders to compel the majority shareholder to purchase their shares (sell-out right). As a threshold for triggering both squeeze-out and sell-out right, the Group proposed 90 or 95 per cent of the equity capital.

In October 2002 the Commission presented a new draft directive. This latest proposal has the same scope and principles as it predecessors, but also incorporates some of the recommendations made by the Winter Group. In particular, it introduces a squeeze-out right and a sell-out right, mandates that the bidder pays the same price to controlling and minority shareholders, and it retains the principle that shareholders have to approve defensive measures. Because of tremendous opposition and because of legal problems, the Commission did not include the break-through rule. The proposal, however, voids any restrictions on the transferability of shares and restrictions on voting rights against the bidder once a takeover bid has been announced. This new Article 11 removes a target firms' discretion to exclude a bidder from exercising his corresponding voting rights, say through voting caps, or to prevent him for purchasing further shares. In contrast to the break-through rule, differentiation of votes, i.e., a multi-class security voting structure, is not considered to constitute such a restriction that is rendered unenforceable by Article 11.

5. Corporate Governance

The market for corporate control and corporate governance are strongly interrelated. Corporate governance is concerned with how to allocate control over investment decisions and how to ensure that those entrusted with control use the resources efficiently. A critical aspect of any system of corporate governance is the extent to which control can be contested, i.e., what it takes to remove control from an incumbent manager or controlling owner. Contestability is important ex post because it allows control to be reallocated, but ex ante it also potentially affects the behavior of those entrusted with control. A number of corporate governance mechanisms have developed for resolving the collective action problem among dispersed investors. Hostile takeovers are one important such mechanism promoting contestability. But these mechanisms also include large blockholder monitoring, managerial compensation schemes, shareholder litigation, and monitoring by creditors, in particular banks (for surveys see Shleifer and Vishny, 1997; and Becht et al., 2002).

In this section we discuss the role of large (controlling) shareholders in corporate governance and the market for corporate control in contesting their control. For the subsequent assessment it is important to bear in mind that both ownership concentration and takeover market are interrelated with other economic and legal institutions and that their effectiveness as governance mechanisms thus depends on the nature of the whole governance system in which they operate.

5.1. Large Shareholders

An investor holding a substantial equity stake has the incentives, i.e., cash flow claims, to engage in information acquisition and monitor management. He or she also has considerable voting power to put management under pressure. Indeed, several theoretical models show that a large shareholder engages in costly monitoring, thereby partially overcoming the collective action problem among dispersed shareholders (Becht et al., 2002). Starting with Demsetz and Lehn (1985), numerous empirical papers examine the relationship between ownership concentration and firm value/performance for a given country, typically the US (for a survey see Holderness (2002)). The recent law and finance literature has broadened this debate by analyzing this relationship across different legal regimes (countries). In support of the view that large shareholders play a positive role, large shareholdings are found to be associated with higher turnover rates of CEOs and directors, with lower compensation for top management, and with lower levels of discretionary spending, such as advertisement (Denis and McConnell, 2002; Holderness, 2002). However, the empirical evidence on the effectiveness of "shareholder activism" in the US finds a negligible impact of large institutional owners (Becht et al., 2002). Overall, the international evidence indicates that ownership has most often a positive impact on firm value and that this relationship varies both by blockholder identity and by country (Denis and McConnell, 2002). As regards the latter, ownership concentration is found to have a stronger positive impact on firm performance in countries with less legal investor protection.[14]

Concentrated ownership has, however, also its costs. Indeed, large shareholders can abuse their power to extract more benefits possibly at the expense of the small shareholders (Shleifer and Vishny, 1997).[15] Not all benefits accruing from controlling a firm can be written into a contract and enforced in a court. These so-called private benefits of control, as distinct from the contractible

[14] Burkart et al. (2002) show in unified model of managerial succession how family control emerges in regimes with weak legal shareholder protection and widely held firms in regimes with good legal protection

[15] Other costs associated with (partial) ownerhip concentration are reduced risk sharing, reduced market liquidity, excessive risk taking in highly leveraged firms, or ex post expropriation of managerial rents thereby stifling initiative ex ante (Becht et al., 2002).

security benefits, can come from many sources. They may come from making decisions that benefit a particular investor (or management) at the expense of other investors. Alternatively, they may be the power and prestige that is associated with the control over a firm and the influence it may give over social and political events. Demsetz and Lehn (1985) propose the term "amenity potential" for this latter type of private benefit that does not dilute the claims of other investors but increases total utility to investors. Nonetheless, such amenity potential may distort managerial decisions and prevent value increasing control shifts from taking place.

The size of private benefits and the extent to which they come at the expense of firm value are a source of controversy among researchers. One method to quantify these benefits is to measure the difference between the per share price in the sale of a controlling block and the share price after the announcement of the block trade. Applying this method, Dyck and Zingales (2001) document 412 transactions of a controlling block in 39 countries. In some countries private benefits, by this measure, appear to be very large. For example, 11 Brazilian transactions show an average premium of around 65 per cent, while in the United States and Canada this figure is 2 per cent. In Europe the range of variation is somewhat smaller, but in Italy and Portugal the mean premium were 37 and 20 per cent, respectively, as compared to most other European countries with mean premia below 10 per cent.[16]

The authors' interpretation is that these large valuations of private benefits reflect possibilities to steal assets from companies, but they cannot rule out that amenity potential is involved as well. In both interpretations, non-contractible private benefits play an important role for the incentives of (compensation to) managers and possibly large blockholders. The size of these benefits appears to be inversely related to the extent to which a country's legal rules protect (minority) investors (LaPorta et al., 1997 and 1998). Closely related, several studies document that the accumulation of control rights in excess of cash flow rights – whether through dual class shares, pyramids or cross-holdings – has a negative impact on share value, suggesting that private benefit are extracted at the expense of small shareholders (Denis and McConnell, 2002).

The conflict between controlling blockholder and minority shareholders may be mitigated by the presence of additional blockholders. A second or third blockholder can provide monitoring or prevent collusion between controlling blockholder and management. In support of this notion,

[16] Measures of private benefits using the control premium should be treated with considerable care since the size of the premium depends on many things such as the inequality of voting power, the extent of competition in the market for

Lehman and Weigand (2000) find a positive impact of a second blockholder on the profitability of German listed firms. Volpin (2002) documents that valuation of Italian firms is higher when a voting syndicate, as compared to a single shareholder, controls the firm. Faccio et al. (2001) report higher levels of dividends in Western Europe when a second blockholder exist, but the reverse in East Asian countries.

To sum up, controlling shareholders can be effective monitors, but they can also extract private benefits at the expense of other investors and stakeholders in the firm. Similarly, large equity ownership by managers also gives rise to two conflicting (alignment and entrenchment) effects: On the one hand, it aligns the interests of the manager with those of the other shareholders, thereby leading to better performance. On the other hand, larger equity stakes let managers pursue their own goals (possibly at the expense of the shareholder) with less risk of reprisal, i.e., it entrenches managers. Both sides of ownership concentration are well documented in numerous empirical studies (which often do not distinguish between ownership by managers and outside blockholders). The empirical evidence is inconclusive on whether, on balance, the positive or negative effects of ownership concentration dominate. Furthermore, ownership concentration is found to be much more prevalent in countries with weaker legal protection even though the agency conflict between large and small shareholders is exacerbated in these countries.

5.2. Contestability and the Market for Corporate Control

An important aspect of a corporate governance system is the extent to which it allows control transfers. Circumstances may and do arise in the evolution of a firm when a change of control is the optimal course of action, say because the current CEO proves unable or unwilling to adjust to a new environment. The most direct way to achieve contestability is through an active market for corporate control. A functioning (hostile) takeover market subjects firms to a continuous auction process: whenever an outside party is able to improve the value of existing corporate resources it can bid for the firm's control. Thus, takeovers allow to replace incumbent managers, who are either less competent or are not acting in the shareholders' best interest. In addition, the mere threat of a takeover affects the behaviour of those entrusted with control, i.e., disciplines them.

Contestability of control should, however, not be the sole criterion. There are other reasons for and modes of changing control. A control transfer can also be efficient simply because the controlling

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corporate control, the size of the block sold, and the distribution of shares in the target firm. The average premium in countries also varies over time in ways that are hard to explain (Becht et al., 2002).

party wishes to sell. In this case access to a liquid market for control is important for corporate governance. Controlling owners may want to cash out for a number of reasons, e.g., lack of a family successor, lifetime consumption, or just liquidity needs. The US venture capital industry illustrates that the possibility to exit investments is important for encouraging entrepreneurial activity. Venture capitalists' investments are normally not liquid and young firms backed by venture capitalist often do not generate significant returns. Venture capitalists realize the returns on their investments through private sales of the venture to another firm or initial public offerings and subsequent open market sales. The prospect of such exits is crucial for the young firms' ability to attract venture capital in the first place.

The importance of contestability also depends on the nature of the governance system. A controlling investor is much less likely to oppose an efficient control transfer because selling is an attractive option. By contrast, resistance has much lower opportunity costs for a manager of a widely held firm who has nothing to sell. Indeed, managers who gain financially from a successful takeover by owning an equity stake are found to resist takeovers less (Burkart, 1999).

Furthermore, contestability has benefits as well as costs. Takeover offers the possibility to bring in a new management that can increase firm value, and the threat of a takeover serves as a disciplining device. But takeovers may also be the manifestation of the managers' ability to pursue their own interests at the expense of the shareholders. Indeed, most takeovers are undertaken not by corporate raiders but by firms headed by professional managers (Burkart, 1999). Similarly, the threat of a takeover may exacerbate the agency problem. Rather than disciplining them, the threat may induce managers to undertake manager-specific investments that make them less easily replaceable. Closely related, the prospect of being fired without proper compensation for current private benefits may undermine the manager's willingness to invest long-term human capital in the firm, and shareholders may worry about dilution of their claims in connection with the sale or under new management.

Ultimately, the degree of contestability of controlling owners and managers is a product of the interaction of all the mechanisms of the corporate governance system. Finding the optimal level of contestability is a key problem in corporate governance. The benefits of contestable control rights must be weighed against any loss of incentives to engage in entrepreneurial activities or large shareholder monitoring. As we have argued, contestability may also come at the expense of minority shareholders; the level of minority protection affects the costs of taking over a firm.

6. Core Takeover Provisions: An Economic Analysis

In this section we examine the three regulatory measures that are at the center of the takeover regulation debate. We first briefly review the familiar arguments in favour of the principle that shareholders have to approve defensive measures. Thereafter we analyse the mandatory bid rule and the break-through rule. We show that they interact with each other and how their combined effect depends on the characteristics of both bidder and target firm. This analysis draws on Bebchuk (1994) and Burkart et al. (2000). Bebchuk compares the incidence of majority block transactions in the absence of the mandatory bid with the incidence of such control transfers in a regime with the mandatory bid rule. Burkart et al. analyse a bidder's choice between a negotiated block trade and a tender offer when attempting to gain control over a firm with a dominant minority shareholder. We also provide a more formal treatment of the arguments in separate boxes.

6.1. Takeover Defenses

Many commentators consider takeover defenses as an entrenchment device whereby managers protect their private benefits at the expense of the shareholders: By making bids more costly, defensive measures reduce the number of takeovers and hence the disciplinary force of the market for corporate control. Others argue that defensive measures reinforce the bargaining role conferred on management. Since shareholders are too numerous and lack coordination, they need the management to negotiate on their behalf. Providing the management with the power to defend the company benefits shareholders. It prevents coercive bids and by delaying an initial bid it provides the necessary time to generate competition among bidders, once a company has come into play. Accordingly, the increase in the bid premium due to defensive measures dominates the negative deterrence effect, i.e. the reduction in the probability of a bid. Empirical evidence on takeover defenses does not resolve the debate. First, it is not possible to observe how many takeovers have been prevented by defensive measures. Second, the evidence on the deterrence effect is inconclusive (Becht et al., 2002).

When analyzing defensive measure it is important to distinguish between the impact of defensive measures and the power to undertake them. Takeovers may potentially be disruptive for the pursuit of long-term profitable strategies, but shareholders should take this into account when accepting or rejecting a particular bid or when voting on defensive measures. The conflict of interests between managers and shareholders is well documented in the empirical literature (Shleifer and Vishny, 1997). This conflict is particularly pronounced in takeovers: the turnover rate for top managers significantly increases following the completion of a tender offer, and those managers who lose their jobs have difficulties finding another senior executive position (for a survey, see Burkart, 1999). If a manager can apply defenses without shareholder ratification, he may abuse this discretion in order to secure his position. Although it is difficult to distinguish personal motives from bargaining on behalf of the shareholders, evidence suggests that managers resist to protect their private benefits. For instance, managers seem less inclined to resist when they gain financially more from a successful bid. Consequently, shareholders need to supervise the manager's defensive actions closely, if they want to ensure that these are indeed taken in their interest. Shareholder control is surely improved by giving them the authority over takeover defenses. Thus, defensive measures should be subject to shareholder approval.

The new Article 11 of the draft directive rules out ceilings on shareholdings (for bidders) and restrictions on the voting rights of already purchased shares. This provision clearly accords with the above reasoning and with the principle of shareholder decision-making. It removes the discretion of management to veto share purchases by any (potentially) hostile bidder or to limit his voting rights. In fact, the rule goes further. It also deprives management of the possibility to try to convince all other shareholders to adopt such restrictions against a bidder. Restrictions on transferability and voting rights are rendered unenforceable.

6.2. Mandatory Bid Rule

In the absence of the mandatory bid rule, a controlling minority shareholder, henceforth the incumbent, may sell his block at any price that an outside buyer, henceforth the rival, is willing to pay. Also, the rival has no obligations to let minority shareholders participate in the control transaction. Hence, such a block sale takes place whenever it is mutually beneficial for incumbent and rival. Due to the free-rider behaviour, small shareholders are not willing to sell their shares for less than the value of the share after the block trade. Consequently, the rival does not gain from making a voluntary tender offer and merely acquires the controlling block.[17]

Insert BOX II

[17] One reason why a rival may nonetheless prefer to acquire all shares is that it enables him to transfer losses and profits between firms to minimize his tax obligations. By contrast, with a controlling interest of less than 100 per cent of the

As proved in “Box II: Mandatory Bid Rule and Control Transfers”, such control transfers necessarily benefit both incumbent and rival, but may have a positive or negative impact on the (wealth of the) small shareholders. When the incumbent’s private benefits are relatively small compared to the rival’s private benefits, a control transfer can be mutually beneficial even if the loss in security benefits exceeds the gains in private benefits. Similarly, when the rival’s private benefits are relatively small compared to the incumbent’s private benefits, incumbent and rival may not want to trade the block even though a control transfer would be value increasing.

The mandatory bid rule proposed by the Winter Group and the Commission in its latest proposal requires the rival to offer small shareholders the same per share price as he has paid the incumbent in the block trade. In such an environment, a control transfer takes place only if the rival creates sufficient added value that enables him to pay the control premium also to the small shareholders. Due to the redistribution from rival to small shareholders, the mandatory bid rule has two opposing effects (for details see Box II). On the one hand, it prevents any value decreasing change of control, and if a control transfers takes place all parties including the minority shareholders gain. The mandatory bid rule forces the rival to internalize any negative externality that a control transfer may have on the shares owned by the small shareholders. Consequently, he is never willing to acquire the firm, unless a control transfer is efficient. On the other hand, the mandatory bid rule increases the likelihood that a value increasing control transfer fails to take place. Having also to pay the control premium to the small shareholders can inflate the total purchase price beyond the rival’s willingness-to-pay, even though a control transfer would add value. Thus, the mandatory bid rule can also impose losses, i.e., forgone share value improvements, on the small shareholders.

Which of the effects dominates is an empirical question. For the US, empirical studies find that trades of large blocks (and block formations) are on average associated with abnormal share price increases. While the market appraisal of block transfers is more favourable for trades followed by a full acquisition, cumulative abnormal returns are also positive when no subsequent full takeover occurs (Holderness, 2002). These findings seems to refute the claim that block trades are undertaken with the purpose of looting companies at the expense of small shareholders. Even though small shareholders are harmed in some transactions, the average share value increases

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shares, taxes must be paid separately on each firm’s profit, thereby preventing such tax optimization (Bergström et al., 1994) suggest that improved management is the primary source of gains in block trades.[18] Thus, large as well as small shareholders benefit from the absence of a mandatory bid rule. But whether this holds more generally can only be established through further empirical work.

6.3. The Break-Through Rule

From an economist's viewpoint, the novel and interesting contribution of the Commission's Winter Group is the break-through rule. The break-through rule enables an investor who holds a certain fraction or more of the equity capital to break through the firm's existing control structure and exercise core control rights such as replacing top management. With the proposed threshold of 75 per cent, the rule implies that current controlling minority shareholders who own less than 25 per cent of all shares lose their veto power over a control transfer. Bennedsen and Nielsen (2002) identify how many firms in the EU (except for Greece, Luxembourg, and the Netherlands) would be likely to be affected by the proposed break-through rule. In their sample of 5,126 publicly traded European firms 20 per cent have dual (multiple) class shares. In 3 to 5 per cent or 33 to 49 of the firms with dual class shares the (group of) controlling owners would lose their veto power over a control transfer if the break-through rule were to be applied. In addition, a large number of firms with controlling blocks close to the 25 per cent threshold would potentially be affected when issuing equity. These firms are mainly from Denmark, Germany, Italy, and Sweden, and 20 to 33 belong to the group of the largest European firms.

The formal analysis in "Box III: Break-through Rule and Control Allocation" examines how and when a controlling minority shareholder is ousted by an outside rival in a regime with a break-through rule. While the subsequent discussion presuppose a firm where the proposed break-through rule eliminates the controlling shareholder's veto power over a control transfer, much of the analysis is also applicable to firms with non-controlling minority owners. Control or substantial influence over a firm does not necessarily require a majority of votes. In particular, when the remaining shares are dispersed, a minority block may be sufficient. For instance, neither the Ford nor the Wallenberg families own a majority of votes.[19]

[18] The reported gains to small shareholders do, however, not imply that a control transfer through a block trade is to be preferred to a control transfer through a tender offer (Burkart et al., 2000).

[19] In the sample of Bennedsen and Nielsens (2002), 17 per cent of the firms with dual class shares have a dominant minority shareholder, who holds (at least) ten times as many voting rights than cash flow rights without possessing the majority of votes. Among these firms, a significant number are European top-500 firms, such as Fiat and Ericsson. The introduction of the break-through rule would considerably weaken the position of the dominant shareholder.

Insert BOX III

By making a firm with a controlling minority shareholder akin to a firm with dispersed ownership for which incumbent and rival compete, the break-through rule indeed facilitates the transfer of control, as intended by the Winter Group. The intuition for this is as follows: The break-through rule gives the rival the option of bypassing the incumbent to take control of the firm rather than seeking his agreement. Since the negotiated block trade with subsequent mandatory bid is the more expensive mode of gaining control, the rival will always choose to circumvent the incumbent and directly make a tender offer. This leaves the incumbent with no other possibility than to compete if he wants to retain control. Hence, provided that rival and incumbent can finance bids equal to their valuation of the entire firm, the party with the higher valuation prevails. Thus, in the absence of wealth constraints, the break-through rule ensures an efficient allocation of corporate control. It seems, however, plausible to assume that many - if not all - incumbent controlling minority shareholders are financially constrained. If not, they could regain their veto power over a control transfer by increasing their block above the 25 per cent threshold. Once wealth constraints are taken into account, control allocation need no longer be efficient in a regime with the break-through rule.

When assessing the merits of the break-through rule, it is worthwhile to reflect on the reasons why value increasing control transfers may fail in the first place. As shown in Box II, large private benefits of the incumbent can prevent efficient control transfers. The Winter Group seems rather biased to focus on this explanation and to view controlling minority shareholders as the major obstacle to takeovers and corporate restructuring in Europe. The Group seems to forget that the mandatory bid rule, that is (in the most stringent form) part of the Group's recommendations is also a reason why value-increasing control transfers can fail. The break-through rule does not only allow the rival to bypass the incumbent but also spares him the cost of having to pay all small shareholders a control premium. That is, the break-through rule makes value increasing control transfers feasible that are frustrated either by the incumbent's opposition or by the mandatory bid rule. Hence, if promoting an active takeover market is a primary objective one may argue in favour of a regime that combines break-through rule with no or a less stringent mandatory bid rule.

When the incumbent cannot compete with the outside rival for control, the break-through rule has also undesirable effects for the small shareholders as the analysis in "Box IV: Break-Through Rule and Minority Protection" establishes. Most notably, the break-through rule can undo the added (minority shareholder) protection that the mandatory bid rule provides. It enables the rival to gain control with a bid equal to the post-takeover (minority) share value, thereby putting small shareholders in the same position as in a regime without the mandatory bid rule. Furthermore, it allows for the possibility that due to the coordination problems among small shareholders a bid succeeds even though it is against their collective interests.[20]

Insert BOX IV

The break-through rule is clearly against the interests of the incumbent controlling minority shareholders; it eliminates their veto power over a control transfer and reduces the prospect of getting compensated for the forgone private benefits in a control transaction. As a result, controlling blocks with less than 25 per cent of the equity capital will (drastically) lose in value. This loss will be reflected in smaller (or even zero) price differentials between shares with high voting power and shares with low voting power and lower premium paid in block trades to the extent that such transactions continue to take place (without triggering a mandatory bid). It also seems likely that controlling minority shareholders respond to the introduction of the break-through rule and try to circumvent it. One way to undermine the break-through rule is the approval of defensive measures in a general shareholder meeting. By virtue of owning a majority of the votes, the controlling minority shareholder can de facto unilateral decide to frustrate a bid. The Winter Report shuts down this option by prohibiting the use of disproportionate control rights in votes on defense measures.

As already mentioned, raising the block size above the 25 per cent threshold is the most straightforward way to neutralize the break-through rule, provided that the necessary funds are available. According to the estimates of Bennedsen and Nielsen (2002), this strategy is only a valid option for a few firms. The adoption of a pyramidal structure (adding one layer in the pyramid), cross-shareholdings, or other devices for separating ownership and control are alternative means to avoid the risk of becoming a victim of the break-through rule. In fact, the Winter Group explicitly acknowledges that pyramids and dual class shares serve the purpose of keeping control with little equity capital. Nonetheless, the Group recommends that the break-through rule should not apply to pyramids because it would be too complicated and expensive. Not surprisingly, the Report has been criticized for exempting or even promoting pyramids, thereby affecting existing corporate governance arrangements asymmetrically (Bebchuk and Hart, 2002).

[20] The same coordination problem can cause the failure of value increasing takeover bids. All shareholders prefer the bid to succeed, but each wants to "free-ride" to get the entire value improvement. That is, the failure of value increasing bids is nothing but the flip side of the success of value decreasing bids.

Bennedsen and Nielsen (2002) point out that the introduction of the break-through rule may also have an impact on firms in which the controlling minority shareholder currently owns more than 25 per cent of the equity capital. At least some of these firms are likely to be restricted in raising new equity capital without falling under the break-through rule. For such firms the break-through rule may well increase the cost of new funds or limit its availability.

Finally, it should be noted that that the break-through rule represents a major ex-post intervention in the property rights of controlling minority shareholders. Such interventions raise, besides fundamental fairness issues, the prospects that there will be more in the future, thus creating uncertainty about the basic property rights. In terms of our analysis this would undermine the incentives to hold controlling blocks in the first place.

7. Takeover Regulation and Corporate Governance in Europe

The impact of specific regulation differs fundamentally across countries in Europe, largely due to the differences in the predominant patterns of ownership and control in individual firms. The mandatory bid rule and the break-through rule have no impact when a firm's shares are widely dispersed. When ownership and control are concentrated, more precisely when there are controlling minority shareholders with less equity than the threshold for a break-through rule (and the controlling owner is wealth-constrained), the two rules have opposite effects. If only the mandatory bid rule is binding, it will increase entrenchment. If the controlling owner uses dual-class shares to separate ownership and control, he or she may well respond by forming the more control-effective pyramids, thus enforcing entrenchment further. We saw that as many as one-fifth of all listed firms in Europe used shares with differentiated votes (Bennedsen and Nielsen, 2002). In a substantial number of these firms, the controlling owner would incur control losses without receiving any compensation. And an even larger group of firms would be constrained in raising equity because their control block would otherwise fall below the break-through threshold.

More generally, as our analysis has demonstrated, there are also obvious limits to what can be achieved through takeover regulation, in any system. Takeover decisions do themselves suffer from agency problems, in fact takeovers may be as much manifestations of agency problems as solutions to them. Takeover regulation affects the distribution of the takeover gains among the bidding firm and the target firm, and between a controlling owner and minority shareholders in the target, and thus the incentives to make bids. But it is not possible to screen out bad bids (primarily motivated by control benefits) without also preventing value enhancing bids. Measures to protect minority investors in takeovers increase the costs of taking over, thus reducing contestability.

Achieving contestability in a corporate governance system like that of Continental Europe is not trivial. With large controlling stakes the likelihood of a hostile bid succeeding is small. Managerial compensation schemes are unlikely to be as powerful, or as important, when a large controlling shareholder can easily fire management. Similarly, the board of directors cannot be expected to play the same independent function as in a widely held firm, because the members sit there on a mandate from the controlling owner. We will return to what could possible be achieved through other mechanisms such as institutional investor monitoring, litigation, and media.

Moreover, to the extent that takeover regulation discourages monitoring by controlling shareholders this would increase the discretion of managers. Any evaluation of takeover regulation thus has to compare not only the costs and benefits of controlling shareholders but also the costs and benefits of its alternative, the managerially controlled firm. The evidence on the relative performance of firms with controlling owners and those with dispersed shareholders does not yield conclusive results (Becht et al., 2002). This should not come as a surprise, given the strong interrelationship between competition, the firm’s internal organization and ownership concentration. Moreover, as we discussed, such comparisons are extremely difficult since the effects of particular ownership and control structures depend critically on the entire corporate governance system.

Comparisons at the level of systems also do not yield clear results. The study by Dyck and Zingales (2002) on control benefits using premia in block transactions suggests substantial variations across countries, but the differences are rather small among developed market economies. Examinations of managerial dismissals following shocks to earnings, cash flows, and stock prices suggest no significant differences across countries (Kaplan, 1997). However, the mechanisms through which turnovers of management are achieved differ fundamentally. In Japan, for example, the company’s house bank becomes more active, while in the United States board activity increases.

Intervening in corporate governance systems is risky exactly because of the interrelationship between the different mechanisms. If large shareholder monitoring is effectively shut down, it will take time before the other mechanisms adjust. For example, transparency about ownership and control structures and about what owners and managers do is still much poorer in many European countries than in the US. The tradition of litigation is very different, and the courts have a rather limited role in resolving corporate governance issues in Europe.

8. A Regulatory Framework for Europe

There is widespread agreement that the starting point for any regulatory effort in the area of takeover regulation and corporate governance should be contractual freedom. Any intervention must be clearly motivated by externalities stemming from corporate governance failures in individual firms. Even more important, legally signed contracts should be respected. Extraordinary circumstances may require altering contractual rights in existing contracts, such as was done, for example, through the recent Sarbanes-Oxley legislation in the US strengthening the liability of managers and owners for their financial statements. But these interventions risk creating uncertainty about the basic rules and thus undermine the willingness to engage in entrepreneurial activity and invest in companies.

Even when regulation is warranted, self-regulation has proven effective in many countries with the London Rules as perhaps the most prominent example. However, internationalization and potential contagion effects from governance failures in individual firms or on individual exchanges suggest that government intervention is warranted. But government intervention can take several forms and happen at both the national and EU level.

As we have seen, the London Rules, themselves a result from self-regulation, have served as the model for national and EU-level regulators in Europe. But there are at least two alternative reference points. One model is that of the US with its predominance of firms with dispersed shareholdings and considerable variation in corporate laws across states. Potential competition among jurisdictions plays some role in shaping regulation over time, and Delaware has emerged as the state par preference for large listed corporations. In the EU context the US model would imply an EU-level securities markets regulator and subsidiarity in most aspects of corporate law, but with one or two national jurisdictions emerging as the major attractors for large firms.

A second alternative model is that of Canada where corporate law also is state-based but considerable coordination takes place at the federal level. The Canadian example combines a regulatory framework requiring a high level of transparency à la US with a corporate governance system dominated by concentrated shareholdings and extensive separation of ownership and control through pyramiding and differentiation of votes. Minority protection comes primarily from a commonly used general clause against oppression of minority interests. Interestingly, Canada had the same low level of control premium as the United States in the Dyck and Zingales (2002) study. The Canadian model would also allow variation across EU Member States but with extensive coordination at the EU level. For Continental European and Nordic countries reluctant to fundamentally change their system of corporate governance, the Canadian experience offers an interesting alternative to a European framework based on the US and UK experiences.

Our analysis suggested that harmonization has important downsides, in particular when rules have very different impact in different countries. For the same reasons binding EU directives in this area clearly have their drawbacks. At the same time, the ability to freely buy and sell control across Member States is an important aspect of the single market, and these border-transcending aspects of takeover regulation should be the focus of the European Commission. Much of what is in the current draft directive has this focus, but the strict mandatory bid rule has a broader impact and goes against the objectives of contestability and a level playing field. We would argue in favor of an EU framework for takeover regulation that balances the benefits and costs from harmonization recognizing the differences in corporate governance systems and the different impact of individual pieces of regulation. Such a framework would contain both binding directives and recommendations. But what should the recommendations offer, and what elements should possibly be binding?

In some areas there are already binding rules, in particular when it comes to disclosure of ownership and control. But careful examination shows that in many countries this regulation is only implemented superficially (Barca and Becht, 2001). It is often very difficult to get access to the relevant information and even when this information is available the data provided is not sufficient to understand the control structure. Disclosure of ownership and control is critical to the market for corporate control and for monitoring the activities of controlling shareholders. In general, enforcement of existing regulation might be at least as important as introducing new regulation. Binding disclosure standards should be extended to a much broader range of issues, in particular when it comes to managerial compensation. In fact, the most urgent governance reform at the European level at the moment may be to increase transparency. The combination of deliberate concealment of relevant information and generally opaque corporate governance environments presents a serious obstacle to cross-border control transactions in many countries in Europe.

The rules that regulate the takeover process and ensure that shareholders have the right to vote on takeover defenses once a bid has been made are now largely accepted by most countries, even by Germany. Many of the other rules in the draft directive and the Winter proposals are also uncontroversial. Whether these rules are part of a binding proposal or not seems secondary since they would presumably be part of any recommendation and adopted by Member States. The provision in the draft directive (Article 11) that renders restrictions on voting rights and on the transferability of shares unenforceable against bidders should probably be part of a binding directive. Regulatory competition from the US suggests that management or controlling owners may otherwise seek jurisdictions that allow takeover defenses such as e.g., voting caps.

Our analysis has been critical of the strict mandatory bid rule ruling out any control premium. However, even though the mandatory bid rule reduces control transfers, it does in one important way improve investor protection: the mandatory bid rule prevents control transfers in which the gains for incumbent and new controlling (minority) shareholder do not stem from value creation but are redistribution at the expense of small shareholders. Some form of a mandatory bid rule with a reasonably high threshold for triggering and an allowance for some control premium, i.e., a less strict rule than that advocated by the Winter Group could also be part of a recommendation, perhaps even of a binding part to a directive (in practice most Member States already have such a rule). For instance, the rule could put an upper limit on the differential between the price paid in the block transaction and the price offered in the subsequent mandatory bid.

Generally, we argue strongly against wholesale changes of corporate governance systems. The strong interrelationship between the different mechanisms suggests great caution in radical reforms. The combined effect of the mandatory bid rule and the break-through rule, as shown in Section 6, would drastically have reduced the incentives to hold controlling blocks and effectively eliminated controlling shareholders from many companies. Alternatively, the proposal would have triggered new hard to foresee control structures through pyramiding and less transparent arrangements.

In our view, the objective of regulation should not be to intervene in specific control structures or generally discourage controlling blocks. Indeed, we are against discouraging the delegation of control and monitoring to individual large shareholders. Rather we favor an approach that attempts to improve the general corporate governance environment, in particular by greatly increasing transparency through stricter enforcement of existing regulation and an extension of these measures to more areas. Controlling shareholders do in most cases perform some positive function in constraining managerial behavior and they may be critical to some forms of restructuring (sometimes while appropriating considerable private benefits). The broader objective of regulation should be to make monitoring by large shareholders superfluous, not to get rid of them.

In its quest to increase contestability and corporate governance the Commission should rely less one-sidedly on hostile takeovers and proxy fights. The level of contestability in a particular system stems from the combined effects of all the corporate governance mechanisms. Rather than undermining controlling shareholders, and effectively weakening this critically important mechanism of corporate governance, the Commission should try to exploit the other mechanisms. These mechanisms can constrain controlling shareholders and managers and thus also improve the functioning of the market for corporate control. It is encouraging that the second report from the Winter Group, after its mandate had been extended, is on corporate law reform in the EU. Many of the proposals in that report are about strengthening these other mechanisms, in particular the recommendations addressing transparency.

We are convinced that improving transparency is key to activating the other mechanisms, especially minority shareholders and media. More information on what controlling owners and managers do, and how they are compensated would help curb some of the excesses and put pressure on them to perform. We also believe that making managers, controlling owners and board members more accountable through various measures such as standardized fiduciary duties can help. But we are less optimistic that creditors can play a larger role in corporate governance than they already do. Banks are neither capable of nor interested, it seems, in monitoring management on a daily basis.

The bottom line is that no single mechanism is likely to deliver sufficient corporate governance and restructuring. Large institutional investors with a tradition of portfolio-orientation have been drawn into governance in the US. In the UK they have remained more passive. On the European Continent some of these institutions are new, but other institutional investors have been deeply involved in corporate governance. The evidence on their impact is still weak, but more can be done to entice these institutions to play a more important role. Litigation is another area where European experience is limited. In the US the exercise of this mechanism has largely benefited lawyers (Romano, 1991), but it could probably be strengthened in Europe where the risk for abuse appears to be less pronounced due to differences in legal practices. Perhaps some progress could also be made on the independence of directors on boards forcing controlling owners to accept minority shareholder representatives. Independence of auditors is also desirable.

To conclude, any regulatory exercise, in particular at the EU-level, must take into account that a corporate governance system is highly complex and made up of many complementary parts. An intervention in part of the system may have ripple effects that are not immediately obvious and hard to fully anticipate. The different parts of the system fit together and changes in one part may undermine the functioning of another, but changes in one mechanism could also reinforce another mechanism. Consequently, the impact of an individual takeover rule need not be uniform but depends on the context. As we have shown this applies, for example, to the mandatory bid. The strict mandatory bid rule included in the draft takeover directive goes against both objectives set up by the Commission: improved contestability and a "level-playing field". The rule lowers contestability in firms with controlling shareholders, and since it has a differential impact depending on the structure of ownership and control, the rule makes the playing field less leveled.

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