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The non-frustration rule of the UK City Code on Takeover and Mergers and related agency problems: What are the implications for the EC Takeover Directive?

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THE NON-FRUSTRATION RULE OF THE UK CITY CODE ON TAKEOVER AND MERGERS AND RELATED AGENCY PROBLEMS: WHAT ARE THE IMPLICATIONS FOR THE EC TAKEOVER DIRECTIVE?

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I. Introduction

The Takeover Directive, first envisioned in the White Paper on completing the Internal Market,[1] was finally adopted in 2004,[2] after almost 20 years of work. The Takeover Directive is based upon the assumption that the takeover offers numerous benefits to companies, investors, and, ultimately, the European economy as a whole.[3]

The functions of a takeover include disciplining management, stimulating competition, and disseminating good management practice, thus improving the quality of management as well as corporate performance.[4] While one of the major purposes of the Takeover Directive is to mitigate the agency problem in the takeover context,[5] some mechanisms, such as "broad neutrality" (Article 9) and the "breakthrough rule" (Article 11) are nevertheless made optional both at the Member State and at the individual company levels.[6] As a result of the compromise among

[*] L.L.M., Columbia Law School (2009); M. Jur., Oxford University Faculty of Law (2008). I wish to thank Professors John Armour and Simon Deakin for valuable comments on the earlier draft of this paper. The views expressed and mistakes made are, of course, mine alone.

[1] GEORGE BERMANN ET AL., CASE AND MATERIALS ON EUROPEAN UNION LAW 804-805 (2nd ed. 2002)

[2] Parliament and Council Directive 2004/25/EC 21, On Takeover Bids, 2004 O.J (L142) 12 [hereinafter *Takeover Directive*].

[3] *Commission Report on the Implementation of the Directive on Takeover Bids*, SEC (2007) 268 (Feb. 21, 2007). *See also* Paul Davies et al., *The Takeover Directive as a Protectionist Tool?*, European Corp. Governance Inst. Law Working Paper Series, Working Paper No. 141/2010 1, 1–2, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1554616 (stating that "the principal purpose behind the Takeover Directive…was to promote the integration of the national economies constituting the "Single Market" and to enhance the competitiveness of European industry as against non-European rivals by facilitating takeover bids, especially cross-border ones.")

[4] Commission Report, *supra* note 3, at 3.

[5] Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (REIMER KRAAKMAN ET AL. EDS, 2004) 21 (stating that one of the functions of corporate law is to control the conflicts of interest among corporate constituencies, such as those between corporate "insiders" (e.g. controlling shareholders and management) and "outsiders" (e.g. minority shareholders or creditors). All such conflicts bear the character that economists refer to as "agency problems" or "principal-agent" problems.

[6] *See* Scott V. Simpson & Lorenzo Corte, *The Future of Takeover Regulation in Europe*, in UNDERSTANDING COMPLEX FINANCIAL INSTITUTIONS 759, 761–62 (Practicing Law Institute, 2005) ("Initially, the objective of the Takeover Code was to harmonize EU takeover law through the adoption of a

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Member States, whether this Directive can achieve its goal, and to what extent, deserves further consideration.

Article 20 of the Takeover Directive instructs the Commission to carry out a survey on the enforcement and experience of the Takeover Directive in 2011 for the purpose of considering future amendments. To this end, on December 16, 2008, the Commission drafted a checklist for Member States to provide relevant information as to takeover bids taking place in their respective markets.[7]

Whether the Directive really works in the way the Commission had originally intended, however, remains far from clear. Given the fact that many aspects of the Takeover Directive followed the UK City Code on Takeovers and Mergers,[8] the UK experience with regard to the agency problem in the takeover context can provide useful guidance to the revision of the Takeover Directive.[9] Among others, the major weapon for tackling the agency problem under the Takeover Directive, namely, the non-frustration rule, was modeled after the Takeover Code. This paper seeks to explore the functions of the non-frustration rule in the UK and its implications for the Takeover Directive. The rest of this paper is structured as follows: Section 2 outlines the non-frustration rule of the UK's Takeover Code; Section 3 explores the function of the non-frustration rule in tackling agency problems in the takeover context; Section 4 concludes.

II. Non-Frustration Rule of the Takeover Code

Section A of the Takeover Code states that the Code is "designed principally to ensure that shareholders are treated fairly and are not denied an opportunity to decide on the merits of a takeover and that shareholders of the same class are afforded equivalent treatment by an offeror."[10] The non-frustration rule is established to serve the former purpose—to set management aside when hostile bids are imminent so that shareholders have the final say on the merit of the bids.

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pan-European takeover code (along the lines of the UK Takeover Code) that would foster consolidation in Europe by creating a level playing field for companies across the EU . . . The Takeover Directive's effect has been substantially curtailed by political concessions.")

[7] *Commission Checklist for Article 20 of the Directive on Takeover Bids*, at DG MARKT F2/ET D (2008) 74038 (Dec. 16, 2008).

[8] THE PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS (8th ed., 2006), *available at* http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf [hereinafter *Takeover Code*].

[9] It is worth noting that the UK, which has the oldest, strongest "no frustration rule" in the European Union, has rejected the breakthrough rule prescribed by the Takeover Directive.

[10] Takeover Code, *supra* note 8, Section A, at A.1.

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General Principle 3 of the Takeover Code further provides that: "the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid."[11] Furthermore, General Principle 2 reads:

> [T]he holders of the securities of an offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid; where it advises the holders of securities, the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company places of business.[12]

These principles are further elaborated upon in Rules 3, 21, and 37.3 of the Takeover Code. First, under Rule 3.1, the target board is required to obtain competent independent advice on offers and the substance of that advice must be made known to the shareholders.[13] Second, the target board should refrain from making recommendations to the shareholders as to whether to accept any offer, regardless of its fairness, although the target board may communicate to the shareholders that the offer is a fair one.[14] Rules 21 and 37.3 set down a non-exhaustive list of common situations in which shareholder approval is required, such as an acquisition, disposal of a target company's assets of a "material amount," share issues, and entering into contracts in any context other than in the ordinary course of business.[15] The principles, as Professor Davies suggests, cover "any frustrating action, whether specifically mentioned in the Rules or not, and it has been held by the Panel to cover even the initiation of litigation on behalf of the target once an offer is imminent."[16] As such, these provisions do not prohibit corporate actions which carry frustrating effects, but rather require that the decision to undertake such actions be placed firmly in the hands of shareholders during the general meeting.

III. The Non-Frustration Rule and Agency Problems

[11] Takeover Code, *supra* note 8, General Principle 3, at B1.
[12] Takeover Code, *supra* note 8, General Principles 2, at B1.
[13] *See* PAUL DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 716 (7th ed. 2003) (arguing that if the target board does not share the same view of the offer, the directors who are in minority should publish their view and such will normally be requested by the Panel to circulated by the target company.).
[14] *Id*.
[15] *Id*., at 717.
[16] *See* DAVIES, *supra* note 13, at 717.

While defensive tactics are widely accepted in the US, they are strictly prohibited by the UK Takeover Code.[17] Defensives measures, or in Professor Bebchuk's terms, a "board veto," are said to produce *ex ante* and *ex post* agency costs.[18]

Absent a board veto, the takeover threat provides management with stronger incentives to serve the shareholders. Managers will likely determine that better performance would reduce the probability of hostile bids. By contrast, if management were given wide discretion to take defensive measures, managers would most likely assume that, even if they performed poorly and a hostile bid did follow, their veto power would nevertheless enable them either to retain control or at least to extract a favorable deal for themselves.[19] As a result, the takeover threat would lose its disciplinary function and an *ex ante* agency cost would be incurred.

When a takeover bid is on the horizon, the divergence of interests between managers and shareholders leads to potential agency costs. First, managers might elect to block the bid, which might be a beneficial one for shareholders, in order to maintain their position.[20] Second, instead of frustrating the bid outright, the management may exercise their voting power to extract personal benefits for themselves, rather than a higher premium for their shareholders.[21] Professor Bebchuck labeled these agency costs "*ex post*" in that they arise after a bid is made.[22]

In sum, since the senior managers' jobs are at stake in the context of a takeover, management may have strong incentives to frustrate a bid—which may be beneficial from the perspective of shareholders—or to promote a shift of controls that is not, but which would preserve the incumbent management or confer other private benefits.[23] It is against this background that both *ex ante* and *ex post* agency costs are reduced in the UK because the target board is marginalized in the takeover bid process. As we shall see below, however, the agency problem nevertheless survives though various lacunas in the Takeover Code. Notwithstanding the

[17] For a detailed comparison of the takeover regime of the UK with those of the US, *see* John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S and U.K Takeover Regulation* 95 GEO. L. J. 1727 (2007).
[18] Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 991–93 (2002) (while the author does not explicitly refer to the Takeover Code, he nevertheless prefers the proposition that decisions regarding a takeover bid should be in the hands of the target shareholders.).
[19] *Id*., at 993.
[20] Lucian Arye Bebchuk, *supra* note 18, at 991.
[21] *Id*, at 994.
[22] *Id*, at 991.
[23] Paul Davies, *The Notion of Equality in European Takeover Regulation* 1-2 (2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=305979.

non-frustration rule, the target board has never been rendered completely passive in the context of a hostile takeover.

First, incumbent management remains free to persuade shareholders to exercise their rights of choice in a particular way though, for example, submitting their opinion as to the bid price.[24] Second, the target board may appeal to the competition authorities to raise potential competition concerns to obstruct the bids.[25] Third, the non-frustration rule is generally "understood as a negative one and not as requiring incumbent management to take steps to facilitate an offer to the shareholders."[26] In other words, the non-frustration rule is not interpreted to require the target board to give potential bidders access to the targets books and relevant documents in order to facilitate the bid. Moreover, the disclosure rule imposed on listed companies, although intended to prevent insider dealing or market abuse, nevertheless gives the target management more time to take permitted defensive measures, such as seeking white knights.[27]

Among other defects, the most frequently criticized is that, in the UK, defensive actions are forbidden only in cases where the takeover bids have been crystallized.[28] As such, management may seek to entrench itself at an early stage—to take advantage of the less stringent *ex ante* regulation in order to "embed" takeover defense well before any bid comes to light.[29] The rules of the Takeover Code do not extend to pre-bid defensive tactics, so reliance must be placed on fiduciary duties and other provisions under the Companies Act (2006). For instance, sections 549–51 of the Companies Act (2006) require shareholders' approval when issuing new shares. It is apparent that not all board decisions carrying defensive effects are subject to shareholders' approval, therefore the rest still rely upon a fiduciary duty. Thus, the agency problem arises once more.

[24] *See* Paul Davies & Klaus Hopt, *Control Transactions*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, *supra* note 5, at 165.
[25] *Id*.
[26] *Id*.
[27] *See* Paul Davies & Klaus Hopt, *supra* note 24, at 165.
[28] Armour & Skeel, Jr., *supra* note 17, at 1736.
[29] *Id. See also* Report of the High Level Group of Company Law Experts Issues Related to Takeover Bids, at Annex 4, at 74–75. (which identifies that the most frequently used pre-bid defensive measures, including: (1) the acquisition of shares in the company; (2) exercising control in the general meeting (voting cap); (3) exercising control of the board of directors (staggered boards, special appointment, codetermination); (4) exercising control of the company's assets (lock-up); (5) financial problems (e.g. poison debts) or regulatory issues (competition issues).).

Once again, UK practice provides useful guidance. As Professor Armour observes, "embedded defenses are not observed on anything like the scale that they are in the US."[30] This is in part because divergent aspects of the corporate government environment in the UK restrict management's ability to entrench itself. Among all the corporate governance mechanisms, the role of the institutional investor may be the one most crucial to constraining pre-bid defensive measures, since institutional investors can refuse to go along with some defensive measures management may seek to put in place in advance of a bid.[31]

IV. Conclusion

Conventional wisdom has it that the agency problem is the most acute in the takeover context. When a takeover bid is imminent, the divergence of interests between managers and shareholders leads to potential agency costs. The management, given that their jobs are at stake, may either frustrate a hostile bid which is beneficial for shareholders, or exercise their veto power to extract personal benefits. As we have seen, even though the non-frustration rule under the Takeover Code is not a fully fledged passivity rule, it nevertheless represents a good solution to the agency problem by giving decision-making power to the shareholders, rather than target management, when a takeover bid emerges. When considering the future reform of the Takeover Directive, one must bear in mind that, although the UK's Takeover Code solves many agency cost problems, there are other factors that deserve more deliberation, such as ownership structures, interests of stakeholders, and the legal origins of each EU Member State.[32] Any reform which fails to take into account the distinct settings in which individual Member States operate would not secure an optimum outcome.

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[30] Armour & Skeel, Jr., *supra* note 17, at 1736.
[31] *See* DAVIES, *supra* note 13, at 718.
[32] In Germany, for instance, the non-frustration rule is perceived to have a negative impact on co-determination. *See* Christian Kirchner & Richard W. Painter, *Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform*, 50 AM. J. COMP. L. 451, 459 (2002).