

Who writes the rules for hostile takeovers, and why?

The Divergence of U.S. and UK Takeover Regulation

BY JOHN ARMOUR

University of Oxford

AND DAVID A. SKEEL, JR.

University of Pennsylvania Law School

Hostile takeovers are commonly thought to play a key role in rendering managers accountable to dispersed shareholders in the “Anglo-American” system of corporate governance. Yet, surprisingly little attention has been paid to the very significant differences in takeover regulation between the two most prominent exemplars of this system, the United Kingdom and the United States. In the UK, defensive tactics by target managers are prohibited, whereas in the United States, Delaware law gives managers a good deal of room to maneuver.

Existing accounts of this difference focus on alleged pathologies in competitive federalism in the United States. In contrast, we focus on the “supply side” of rule production, by examining the evolution of the two regimes from a public choice perspective. We suggest that the content of the rules has been crucially influenced by differences in the mode of regulation — that is, by who it is that does the regulating. In the UK, self-regulation of takeovers has led to a regime largely driven by the interests of institutional investors, whereas the dynamics of judicial law-making in the United States have benefited managers by making it relatively difficult for shareholders to influence the rules. Moreover, it was never possible for Wall Street to “privatize” takeovers in the same way as

the City of London because U.S. federal regulation in the 1930s both preempted self-regulation and restricted the ability of institutional investors to coordinate.

TWO SYSTEMS

A properly functioning takeover market enhances corporate governance in two related ways. If the bidder brings in better managers after the bid, or can improve the target’s performance by reconfiguring its assets or exploiting synergies between the two firms, there is a direct, cause-and-effect relationship between the takeover and firm value. Takeovers have a second, indirect benefit. If managers have reason to suspect that a hostile bidder will take control if the managers run the company badly, the prospect of a takeover can keep the managers on their toes.

For over 25 years, academics have debated the question of how best to regulate the takeover market. Frank Easterbrook and Dan Fischel proposed that managers be prohibited from defending against a takeover; the company’s shareholders should decide. In response, other commentators argued that managers should be given at least some scope to slow down an initial takeover bid to the extent necessary to get the best-possible price for the company’s shareholders.

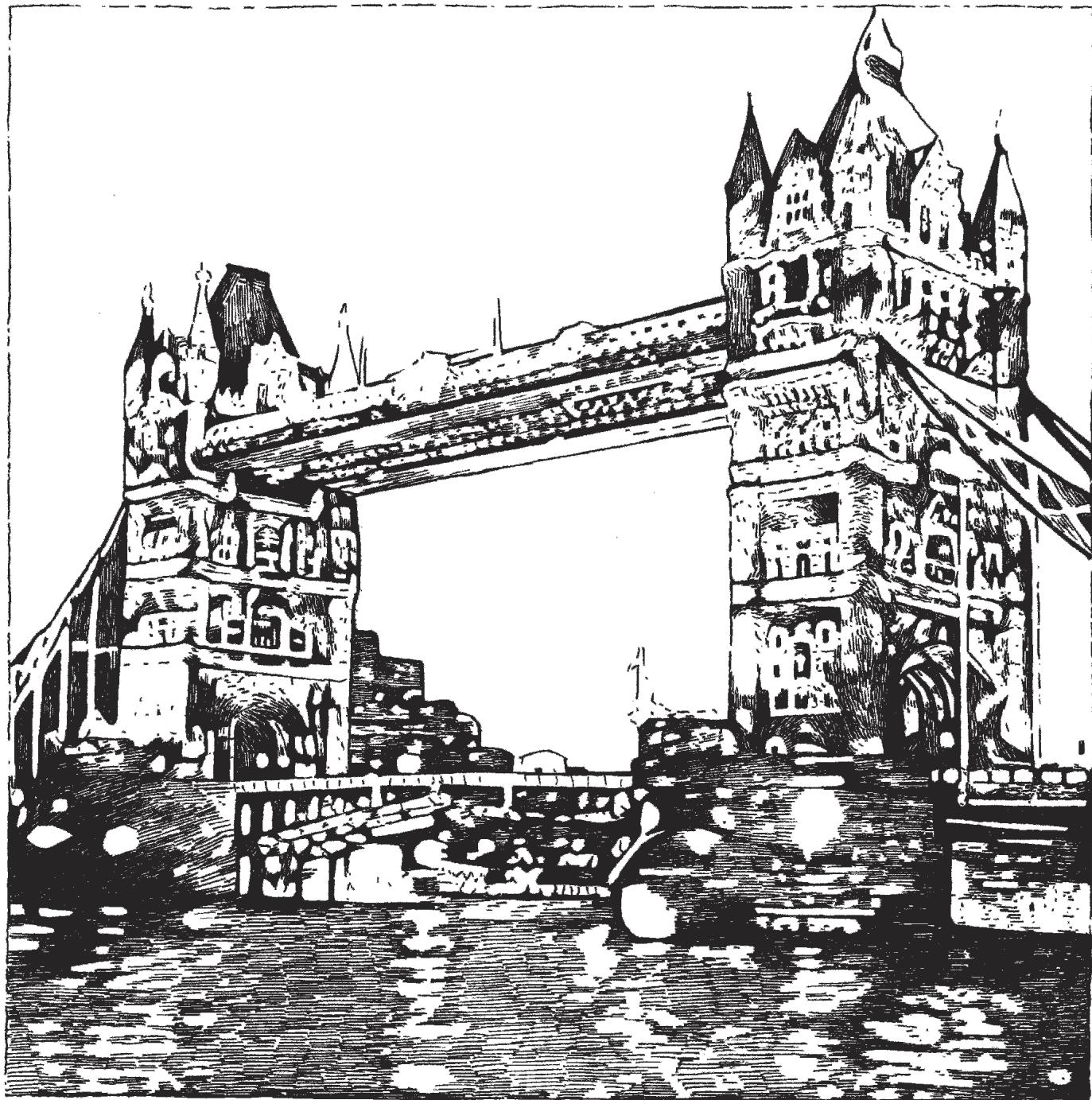
In the United States, Easterbrook and Fischel’s shareholder-oriented approach has been far more successful in theoretical debates than as an influence on actual practice. The Delaware courts dismissed the shareholder choice perspective in several important takeover decisions, emphasizing instead that the company is managed by, or under the control of, its directors.

If we look across the Atlantic, by contrast, we see a remarkably different picture. The UK has explicitly rejected manage-

John Armour is the Lovells Professor of Law and Finance in the Faculty of Law at the University of Oxford.

David A. Skeel, Jr. is the S. Samuel Arsh Professor of Corporate Law at the University of Pennsylvania Law School.

This article is based on a longer piece appearing in the *Georgetown Law Journal* (2007).



rial discretion in favor of the shareholder-oriented strategy for regulating takeovers. Less recognized but of even greater importance, the mode of takeover regulation also looks quite different in the UK than in the United States. In the discussion that follows, we describe the differences in detail and consider whether either approach can be said to be superior.

U.S. VS. UK In the United States, tender offers are regulated under the Williams Act amendments to the Securities and Exchange Act of 1934. That regulation is considered relatively shareholder-friendly. Less friendly to shareholders, however, is the treatment of target managers' responsibilities in the face of an unwanted takeover bid. Managers of a target company are permitted to use a wide variety of defenses to keep

those bids at bay. The most remarkable of the defenses is the "poison pill" or shareholder rights plan, which is designed to dilute a hostile bidder's stake massively if the bidder acquires more than a specified percentage of target stock — usually 10-15 percent. Poison pills achieve this effect — or more accurately, they would achieve this effect if they were ever triggered — by, among other things, inviting all of the target's shareholders except the bidder to buy two shares of stock for the price of one. The managers of a company that has both a poison pill and a staggered board of directors have almost complete discretion to resist an unwanted takeover bid.

In contrast, UK takeover regulation has a strikingly shareholder-oriented cast. The most startling difference comes in the context of takeover defenses. Unlike their U.S. brethren,

UK managers are not permitted to take any “frustrating action” without shareholder consent once a takeover bid has materialized. Poison pills are strictly forbidden, as are any other defenses, such as buying or selling stock to interfere with a bid or agreeing to a lock-up provision with a favored bidder, that would have the effect of impeding target shareholders’ ability to decide on the merits of a takeover offer.

To be sure, the “no frustrating action” principle of the UK’s Takeover Code only becomes relevant when a bid is on the horizon. Thus, managers seeking to entrench themselves theoretically could take advantage of less stringent *ex ante* regulation to “embed” takeover defenses well before any bid comes to light. Such “embedded defenses” range from the fairly transparent, such as the issuance of dual-class voting stock, adopting a staggered board appointment procedure, or the use of “golden shares” or generous golden parachute provisions for managers, to the more deeply embedded, such as provisions in bond issues or licensing agreements that provide for acceleration or termination if there is a change of control. Yet, other aspects of UK law and practice – including rules that prevent effective staggered boards – mean that embedded defenses are not observed on anything like the scale that they are in the United States.

To summarize then, U.S. takeover regulation seems significantly less shareholder-oriented than its UK counterpart, especially in the treatment of defensive managerial tactics.

SO WHAT? The UK’s ban on defensive tactics by managers clearly makes it easier for hostile bids to succeed. Indeed, as Table 1 shows, a mergers and acquisitions (M&A) transaction in the UK is more likely to be hostile, and if hostile, is more likely to succeed, than in the United States. In both countries, hostility is the exception rather than the rule, but in the UK 0.85 percent of takeovers announced during the period 1990–2005 were hostile compared with 0.57 percent in the United States. Of those hostile bids, 43 percent were successful in the UK as opposed to just 24 percent in the United States.

The suggestion of a link between takeover defenses and takeover practice is strengthened by the fact that the rise of anti-takeover mechanisms such as “poison pills” by U.S. firms in the 1990s coincided with a dramatic decline in levels of takeover hostility from the 1980s. Those who view hostile takeovers as a disciplinary mechanism for managers therefore tend to prefer a regime like the Takeover Code that does not permit managers to use defensive tactics. This gives boards a greater incentive to focus on returns to shareholders.

Takeovers, of course, do not always enhance efficiency. If purely redistributional or value-decreasing motives predominate, then it may be desirable to restrict takeover activity. However, the empirical evidence on takeovers suggests that they generally create value. Empirical studies of takeovers in both the United States and the UK have consistently found that target shareholders experience significant positive abnormal returns from a takeover event. In contrast, the empirical findings are more varied with respect to bidder shareholders: some studies report a small gain, others a small loss. Yet even where losses accrue to bidder shareholders, the losses are considerably smaller than the gains to target shareholders, suggesting

that on average such transactions create a significant amount of net value for shareholders.

MORE TAKEOVERS Our provisional conclusion is that the UK’s restrictions on defensive tactics seem preferable to the U.S. approach. Yet one puzzling finding remains: While hostile bids are less likely to succeed in the United States, the overall level of takeover activity, adjusted for the size of the economy, actually seems slightly higher in the States than in the UK, even during the 1990s. U.S. acquirers are now more likely to enter into negotiations with the target’s board (resulting in a “friendly” transaction) than to make a “hostile” offer direct to shareholders.

Does the equivalence in takeover activity imply that U.S. firms are able to “contract around” so as to achieve outcomes that are functionally equivalent to the UK? For three reasons, we are skeptical of this idea. First, a board veto (such as the U.S. system gives managers) will only work to shareholders’ advantage in a takeover situation if the board members are properly incentivized to act in shareholders’ interests. In situations where the board members do not have a sufficient stake in the firm, or are not adequately monitored by outside directors, they may reject worthwhile takeover offers so as to retain their jobs – or accept inferior bids that are coupled with a “bribe” in the form of a handsome retirement package for the board. A functional equivalence claim depends on the implausible assumption that managers, unconstrained by the threat of takeover, will nevertheless agree to other measures that will render them accountable to shareholders.

Secondly, the negative impact for shareholders of protecting the board from takeovers is not only felt at the time of a bid, but manifests itself most strongly in weaker incentives for managers at times when no bid is on the horizon. Because managers can effectively veto a bid, they have little need to fear that underperformance will at some point be “disciplined” by the market. Empirical studies report that the adoption of an anti-takeover law has a negative impact on the stock prices of firms incorporated in that jurisdiction. Similarly, firms that adopt effective anti-takeover devices appear to produce inferior returns for shareholders.

Finally, “incentivizing” the board with equity-based compensation, the principal alternative to direct shareholder choice, is no panacea; this can have perverse effects as well as beneficial ones. As became clear with the U.S. corporate scandals (Enron and WorldCom), heavily options-based pay gives

Table 1

M&A Hostility in the U.S. and UK

1990–2005

Location of target	Announced M&A (public company targets)	Hostile		Hostile completed	
		number	percent	number	percent
U.S.	54,849	312	0.57	75	24
UK	22,014	187	0.85	81	43

SOURCE: Thomson SDC Platinum database

managers an incentive to drive up the company's stock price in any way possible because managers profit if the price rises, but they are not punished if it falls.

The UK system renders managers more directly accountable to shareholders. While it is possible for U.S. firms to contract around its more manager-friendly regime, the costs of doing so seem to be very high. Thus, the differences in the substance of takeover regulation seem to lead to real differences in takeover practice.

DIVERGENT MODES OF REGULATION

Differences in the mode of takeover regulation are even more striking than the results of the two nations' rules. Once again, we begin with the United States.

U.S. takeover regulation is the domain of courts and regulators. The tender offer itself is regulated principally by the Securities and Exchange Commission, which assesses compliance with the disclosure and process rules. Managers' response to a takeover bid, by contrast, is regulated primarily by state courts, which usually means Delaware's Chancery judges and Supreme Court. When a takeover bidder believes that the target's managers are improperly resisting its bid, the bidder generally files suit in the Delaware Chancery Court. The suit argues that the target managers have breached their fiduciary duties and that the managers should be forced to remove their defenses so that the takeover can be considered by the target's shareholders. The key players in the drama are lawyers and judges.

Turn to the UK and the lawyers largely disappear. When a hostile bidder launches a takeover effort and believes that the target's managers are interfering with the bid, the bidder lodges a protest with the Takeover Panel. Originally housed in the Bank of England, the Takeover Panel is now located in the London Stock Exchange building. The Takeover Panel — which includes representatives from the Stock Exchange, the Bank of England, the major merchant banks, and institutional investors — administers a set of rules known as the City Code on Takeovers and Mergers. Both the Panel and the Code were, until very recently, entirely self-regulatory. Although, as part of the UK's implementation of the EU's Takeover Directive, they have now been given a statutory underpinning, this has been designed with the express objective of maintaining the characteristic features of the Panel's approach, which is based on self-regulation.

Takeover Panel oversight differs from the U.S. framework for regulating takeovers in at least three important respects. First, the Panel addresses takeover issues in real time, imposing little or no delay on the takeover effort. In contrast, the

Table 2

Litigation and Hostile Takeovers

1990–2005

Location of target	Hostile number	Hostile litigated number	percent
U.S.	312	106	33.9
UK	187	2	0.1

SOURCE: Thomson SDC Platinum database

Delaware courts take weeks and sometimes months.

Second, lawyers play relatively little role in Takeover Panel oversight. The Panel's members come from the principal shareholder and financial groups, and the staff consists primarily of business and financial experts rather than lawyers. The more flexible approach arguably reduces costs; litigation is an expensive way of resolving disputes. Table 2 shows that approximately one-third of hostile takeovers in the United States are litigated; in contrast, hostile bids are almost never litigated in the UK, where a significant proportion of the regulatory issues are resolved by no more than a telephone call to the Panel Executive. In contrast to the services of litigation lawyers, the Panel does not charge for the issuance of such guidance. Rather, its operations are funded by a fee charged in relation to formal offers, a small levy paid on significant dealings in shares on the London Stock Exchange, and by sales of the Takeover Code.

Given the differences in the use of litigation, we would expect U.S. lawyers to make more money from M&A transactions than their UK counterparts. Data on legal fees in takeovers are currently unavailable. However, as Table 3 shows, leading U.S. firms with an M&A-oriented practice generate significantly more revenue per lawyer and profit per partner than do their UK counterparts.

Of course, law firms' financial performances are affected by a wide range of factors, but those figures are consistent with the conclusion that the U.S. system is considerably more expensive for parties to a takeover. However, diversified shareholders, who stand to participate equally on the winning and losing sides of transactions, would surely prefer to minimize the transaction costs of regulating takeovers.

The final difference between the U.S. and UK modes of takeover regulation is that the flexibility of the Panel's approach allows it to adjust its regulatory responses both to the particular parties before it and to the changing dynamics of business within the City of London. The Code

Table 3

Financial Performance of Leading M&A Law Firms

2004–2005

U.S.	Profits per equity partner/ \$k	Revenue per lawyer/ \$k
Wachtell, Lipton	3,790	2,395
Sullivan & Cromwell	2,410	1,625
Cravath	2,600	1,280
Davis Polk	2,000	1,145
Simpson Thacher	2,370	1,125
UK		
Slaughter and May	1,951	936
Linklaters	1,565	743
Freshfields	1,300	685
Clifford Chance	1,209	685
Herbert Smith	1,501	616

SOURCES: AmLaw 100; The Lawyer Global 100

NOTE: Exchange rate used: US\$1.00 = GBP0.538 (average over period July 1, 2004 to June 30, 2005)

Committee of the Takeover Panel meets several times a year to discuss the operation of the market, assess recent developments, and determine whether any amendments to the Takeover Code are necessary in response. In contrast, U.S. courts make rules in a way that is essentially reactive: changes in the marketplace lead to litigation, following which, the courts pronounce upon acceptable behavior.

An issue that has recently led to controversy in takeover disputes on both sides of the Atlantic provides a simple case study of the process differences we have just described. In a number of recent takeover disputes, bidders have sought to acquire or influence control of a target without triggering disclosure obligations by using derivatives. For example, equity swaps (known as “contracts for differences,” or CFDs, in the UK) are bilateral contracts under which one party essentially takes a bet against a counterparty, who is typically a financial institution, on the price of an underlying security. If party A takes a “long” position in an equity swap with party B, then B agrees (for a fee) to pay A if the price of the underlying security rises; conversely A pays B if it falls. As part of its hedging strategy, B will typically acquire the underlying security, which can then be transferred if necessary to A in settlement of a long position. Because it is fully hedged, B has no financial interest in the underlying security, but B nevertheless holds the voting rights, which it may in practice be persuaded to exercise in accordance with the wishes of A. Through this arrangement, A may be in a position to exercise voting control of the underlying shares without having any beneficial interest in them. Such arrangements were in several recent instances in the UK used to assist bidders in acquiring control of targets without triggering disclosure obligations.

In the United States, a similar strategy achieved notoriety in 2005 in connection with a proposed acquisition by Mylan, a pharmaceutical company, of King, another pharmaceutical. Perry Corp., a hedge fund that held a substantial stake in King, bought and simultaneously hedged 9.9 percent of Mylan’s stock. In effect, Perry bought 9.9 percent of the Mylan votes, in an effort to tip the Mylan vote in favor of the acquisition so that it could profit from the acquisition of its King shares. Perry’s gambit (later abandoned after Carl Icahn, another Mylan stockholder, sued) brought the new vote-buying technique and the potential for abuse to public attention.

The Takeover Panel’s response to similar issues in the UK was to amend the Takeover Code in May 2006 so as to equalize the disclosure treatment of long CFDs (equity swaps) and similar derivative contracts with that of the underlying securities. In the United States, by contrast, the response has been much slower. There are hints of activity at the SEC, but the agency probably lacks authority, without a congressional amendment to the securities laws, to promulgate a substantive rule aimed at the new vote-buying, and there may be limits even on its ability to require additional disclosure. Nor is there any evidence that Delaware will intervene any time soon.

In summary, the U.S. approach gives target managers discretion to defend a bid, whereas the UK gives the decision to shareholders. The principal decisionmakers in the United States are Congress and the Delaware courts. In the UK, by

contrast, informal regulation by the Takeover Panel takes center stage. While neither approach is clearly superior substantively, the UK process seems quicker, cheaper, and more proactive in response to market developments.

FROM PROCESS TO SUBSTANCE

Why have these two countries, with ostensibly similar systems of corporate governance, taken such different paths when it comes to regulating takeovers? We begin with the most obvious explanation, which is derived from the marvels of American federalism. But as we shall see, this “orthodox” story raises nearly as many questions as it answers. We then develop a richer analysis that draws on historical developments, focusing in particular on the influence of institutional shareholders in the UK and on the foreclosure of self-regulation in the United States. Both paths, it turns out, were the largely unintended consequences of legislation that had other objectives.

ORTHODOX STORY For even longer than they have been debating directors’ proper response to takeovers, American corporate scholars have debated whether Delaware’s supremacy as the state of choice for America’s largest corporations is the product of a “race to the bottom” or a “race to the top.” The race-to-the-bottom view posits that state lawmakers cater to managers and thus have powerful incentives to favor managers at the expense of shareholders. Race-to-the-top advocates, on the other hand, believe that market pressures force Delaware and other states to regulate with shareholders in mind. The federalism that makes this state lawmaking possible provides the most obvious explanation for the U.S. approach to takeover regulation.

In the past decade, a subtler version of the original race-to-the-bottom theory has emerged, and has become increasingly influential in corporate law circles. This view proposes that charter “competition” is hardly a competition at all. Delaware, which roughly 60 percent of the largest corporations now call home, has a monopoly share of the market. That monopoly is made possible, in part, by the fact that there is no open, nationwide competition between Delaware and 49 other states. Rather, Delaware competes with just one other state at a time – the “home” state of a corporation that is considering relocating to Delaware. The upshot is that Delaware has at least some ability to favor managers’ interests, and it can charge supra-competitive prices for the privilege of incorporating in the nation’s second smallest state.

It is a short step from this new orthodoxy to a straightforward political explanation for the divergence of U.S. and UK takeover regulation. In the United States, federalism has amplified the voice of corporate managers. Because they worry that managers will pack the company’s bags and move elsewhere if the state is insufficiently attentive to the managers’ needs, state lawmakers have powerful incentives to keep corporate managers happy. This suggests that managers will often get what they want both in Delaware and in other states. In the UK, by contrast, which does not have this federalist structure, corporate managers exert far less influence.

The orthodox account rings true in some respects. Man-

agers clearly do influence the shape of state corporate law, particularly with respect to takeovers. But the federalism story also has at least two puzzling limitations.

First, while it offers a superficially plausible explanation for the general substantive content of U.S. takeover regulation, it implies that Delaware law is likely to be more manager-friendly — and less efficient — than the laws of other states. After all, if Delaware judges and lawmakers have a greater stake in pacifying corporate managers than any other state, their handiwork should pander correspondingly more to managers' interests. Yet this conclusion fits poorly with the existing evidence. Delaware was one of the last states to enact an anti-takeover statute, and its statute gives managers far less discretion than those rushed into the code books by other state legislatures. There is also strong empirical evidence that reincorporating in Delaware increases a company's value, rather than undermining it. Delaware's critics have labored mightily to explain those observations, but the evidence suggests that a theory predicated on an assumption that Delaware corporate regulation is less efficient than other states may not be the whole story.

The second limitation deepens the mystery. The single most striking difference between U.S. and UK takeover regulation is not the substance but the mode of regulation: the United States looks to formal law, whereas norms-based self-regulation holds sway in the UK. Yet the orthodox federalism story does not seem to give us tools for understanding why U.S. and UK takeover regulation differ not just in substantive terms, but also in the principal mode of regulation. A more compelling political account must also explain the divergent modes of regulation.

To identify the starting points for a richer political account, we need only ask which of the players and events that figured prominently in the historical development of U.S. and UK takeover regulation seem to be missing from the orthodox federalism story. The answers, in our view, are institutional shareholders in the UK, and the early 20th century securities and banking legislation that determined the path of U.S. corporate regulation. Together, they hold the key to understanding the divergent modes of regulation in the United States and the UK.

UK SELF-REGULATION Institutional shareholders played a far greater role in the development of UK takeover regulation than in the United States. Every time large financial institutions were poised to play an outsized role in American corporate governance in the 20th century, politicians intervened, forcing corporate ownership to remain fragmented and discouraging big financial institutions from substantially raising their profile.

The 1933 Securities Act and the 1934 Securities and Exchange Act were passed

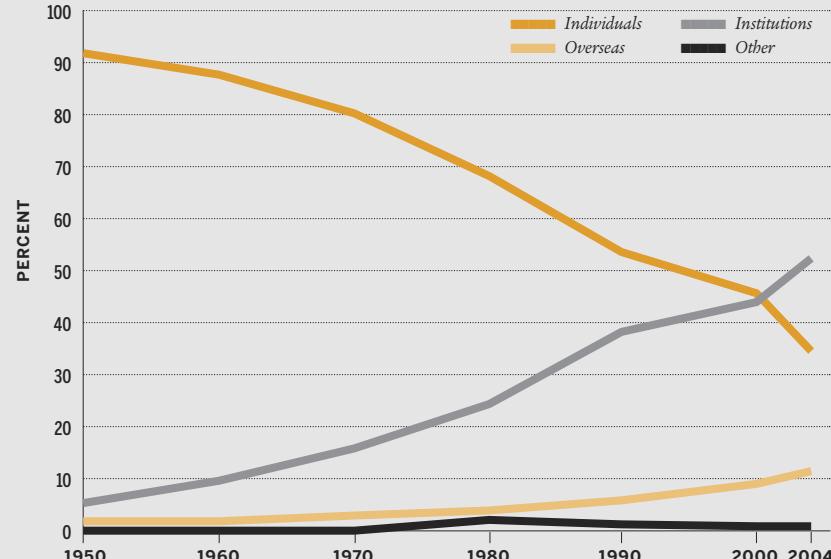
in the wake of the 1929 crash and the early years of the Depression. They sought to correct the perceived market abuses of the 1920s by imposing new disclosure and antifraud regulation. The 1934 Act also established the SEC to serve as the principal policeman of the markets. During this same period, Congress enacted major banking regulation that separated commercial and investment banking (the Glass-Steagall Act), and established deposit insurance to protect Americans' savings (Glass-Steagall, together with the Banking Act of 1935).

With a strong populist wind at its back, the New Deal Congress explicitly sought to restructure American business and finance through these reforms. The banking reforms were designed to break the near monopoly that J.P. Morgan and a small group of other banks had on American corporate finance, and to sharply diminish the banks' role in the governance of America's largest corporations. The creation of the SEC, and the SEC's authority to oversee the stock exchanges, then put a governmental regulator in the oversight role that had previously been occupied by the banks and other Wall Street insiders.

Although mutual funds, pension funds, and other institutional shareholders now hold a large percentage of U.S. equities, their holdings were relatively insignificant during the crucial periods in the development of takeover regulation (see Figure 1). It was only in the 1990s — by which time the contours of Delaware's takeover doctrine had largely been established — that U.S. institutional investors became a significant force in corporate governance. The impetus behind the legislation that restricted institutions was a populist desire to rein in the monopoly power of the "Money Trust." This had the largely unintended consequence of granting managers considerable autonomy from shareholder control.

Figure 1

U.S. Share Ownership Patterns 1950–2004



SOURCES: "Economic Implications of Changing Share Ownership," by Benjamin M. Friedman, *Journal of Portfolio Management*, Vol. 22 (1996); Board of Governors of the Federal Reserve, *Flow of Funds Accounts in the United States, 1995–2005, Table L213: Corporate Equities*

In contrast, institutional investors became important much earlier in the UK. The proportion of UK stocks owned by pension funds, insurance companies, and unit trusts (the British equivalent of mutual funds) rose dramatically during the 1960s and 1970s, as Figure 2 illustrates. Unlike their American counterparts, British institutions were not held back from investing in stocks; indeed, quite the reverse.

The emergence of strong institutional investors in Britain was an unintended consequence of various legislative measures that had the effect of actively promoting their ownership of stock. Three were particularly important: The first, and probably most important, factor, was the punitively high rates of marginal taxation applied to investment income for individuals from the end of World War II until 1979. The top marginal rate was 90 percent for most of that period, rising to 98 percent from 1974 to 1979. Second, tax relief was at the same time accorded to collective investment schemes. The most extensive was that granted to pension funds, which were entirely exempt from tax on dividend income, part and parcel of the UK's favorable tax environment for private pension plans. However, insurance companies also enjoyed a favorably low rate of tax on dividend income. Together, those factors exerted a pressure away from individual and toward collective ownership of shares.

As Figure 2 shows, institutional investors first started to accumulate significant proportions of shares in British companies in the mid-1950s. By the mid-1960s, they were firmly established at the heart of UK corporate governance. Their ownership continued to rise until the early 1990s. For the whole of that period, the institutions were a catalyst for developments in UK corporate governance.

The observed strategy was one of coordinated lobbying for rules that were expected to maximize the joint welfare

of institutional investors. The Takeover Code is a good example. Institutional investors were involved at every stage of the drafting of the Code, right from the 1959 Notes of the Amalgamation of British Industry, the Code's predecessor. Because institutional investors have a clear interest in rules that maximize expected gains to shareholders, it is not surprising that the emergence of a pro-shareholder approach to takeover regulation should have coincided with the emergence of institutional investors as a significant force in British share ownership.

UK institutional investors were, in fact, able to go one better than lobbying for their desired rules. They were in many cases able to preempt public regulation entirely by taking charge of enforcement, too. Enforcement of private rules is feasible in an environment where parties interact repeatedly, as UK institutional investors do within the "Square Mile" of the City of London. As repeat players, the institutions were able to agree on a mode of takeover regulation that was much cheaper than litigation, and to threaten reputational sanctions — exclusion from the market — against those who refused to comply with the Code and/or Panel rulings.

A reader more familiar with the U.S. story might ask why British managers were so quiet in all of this. Why did they not lobby politicians for more pro-management rules or push for more active representation in the Working Parties that were responsible for writing first the Notes and then the Code? The first wave of hostile takeovers in the early 1950s did in fact provoke public hostility from corporate managers and trade unions who denounced "speculators" intent on the "predatory dismembering" of British businesses solely to "tak[e] out as much cash as possible in the shortest time." Moreover, at this time, institutional investors would have been a much less powerful force. Yet the close links between the government and the Bank of England, on the one hand, and the Bank and City institutions on the other, meant that City voices would have been loud advocates in ministers' ears for non-interventionist solutions. Furthermore, while many politicians — particularly in the Labour Party — sympathized with the popular caricature of the bidder as "asset stripper" and were pro-intervention, the Labour Party's strongly pro-union policies and penchant for nationalization would have led managers to think twice before inviting greater regulation of their affairs from this quarter.

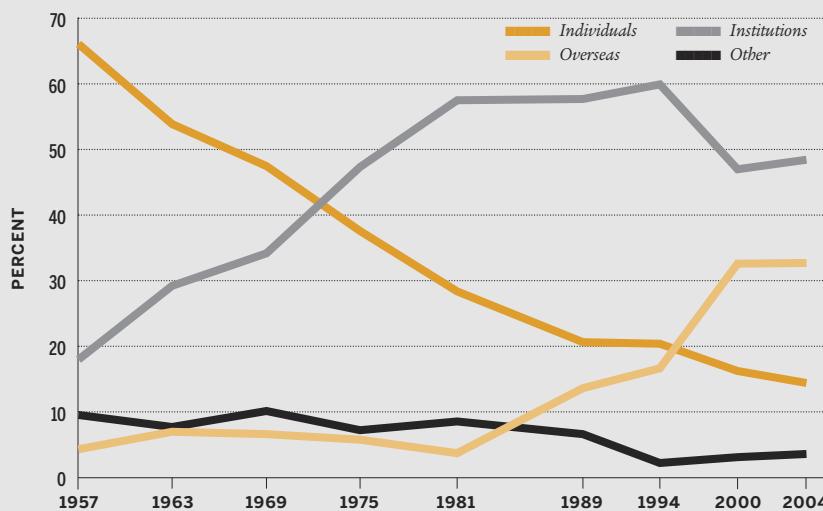
It appears that British managers turned not to government, but to their allies amongst the financial institutions — the "blue-blood" merchant bankers — to whom their goodwill was important as underwriting clients. Managers' initial tactic was to try, in alliance with this group of bankers, to establish a norm that hostile bids were illegitimate.

Things came to a dramatic head in the

Figure 2

UK Share Ownership Patterns

1957–2004



SOURCES: Office for National Statistics, Share Ownership Report 2004; "The Pattern of Ordinary Share Ownership, 1957–1970," by John Moyle, University of Cambridge Department of Applied Economics Occasional Paper No 31 (1971).

well-publicized battle for British Aluminum (BA). At the end of 1958, BA managers received approaches from two rival camps: the American firm Reynolds Metal Company in partnership with UK-based Tube Investments (TI-Reynolds), and the Aluminum Company of America (Alcoa). Without informing their shareholders of those developments, BA's board rejected TI-Reynolds' approach, instead agreeing to a deal with Alcoa under which the latter was issued with new shares amounting to a one-third stake in BA. It was only when TI-Reynolds made clear that they intended to go over the BA directors' heads with an offer directly to the shareholders that the directors publicly revealed the Alcoa deal.

The BA board marshaled its establishment allies to fight back. Its merchant bankers, Hambros and Lazard Frères, were two of the oldest and most "blue-blooded" houses. Together, they persuaded a consortium of leading old-school banks and institutions to enter the fray on BA's behalf, openly seeking to influence the outcome of the dispute and presumably to set a precedent. On New Year's Eve 1958, at the height of the takeover battle, a syndicate of 14 City institutions, led by Hambros and Lazard Frères, announced an offer to buy half of any holdings in BA on the condition that investors retain the other half until the TI-Reynolds bid had lapsed. They claimed to have the backing, in secret, of "many large banking institutions and financial concerns," and to have received assurances from the holders of about 20 percent of BA's stock that they would not accept the TI-Reynolds bid. The syndicate urged shareholders — and in particular, institutional investors — to support their cause on grounds of "national interest," alleging that the Alcoa deal was the only way that BA could remain in British hands.

The syndicate's offer led to an outbreak of open sparring within the normally closed ranks of the City's banking community. It appeared to many that the old-school merchant banks were flexing their muscles in an unseemly fashion in order to protect the perceived interests of their clients — the BA managers. Those same managers, in the eyes of many institutional investors, had acted in disregard of the shareholders' interests. TI and Reynolds were advised by Helbert Wagstaff and S.G. Warburg & Co. The latter had been recently founded by Siegmund Warburg, one of the few merchant bankers of the time willing to dirty his hands with hostile bids and regarded by many in the City's establishment as an upstart arriviste. His clients responded aggressively to the syndicate's offer: they upped their bid while at the same time buying BA's shares vigorously in the market. Institutional shareholders sold to them en masse. The whole affair was a very public and expensive humiliation for the members of the City syndicate, who found themselves minority stockholders in a business controlled by TI-Reynolds.

The battle for British Aluminum defused any willingness in the City's old guard to push a pro-management agenda. The obvious lesson that the syndicate's opposition had been an expensive mistake would have been coupled with the forceful realization that the institutional shareholders were now a force to be reckoned with.

The institutional shareholders capitalized on the moral

advantage given to them by the BA affair by seeking to crystallize the norm of board neutrality. A statement was issued by the Association of Investment Trusts, with the support of the British Insurance Association, that in their view "it is wrong for directors to allow any change in control or the nature of the business without referring to shareholders." A few months later, the Bank of England brought together merchant bankers and institutional investor groups to draft the Notes. The principle of shareholder primacy featured highly.

When the trade associations that had drafted the Notes were reconvened by the Bank of England nine years later to prepare the Takeover Code, the Confederation of British Industry, another management organization, was invited to participate in the drafting process. However, by then, management opposition to the idea of hostile takeovers had waned dramatically. Most bids in the 1960s were driven by consolidation, and managers were just as likely to be bidders as targets in that milieu. No serious opposition has since been raised to the idea of the board neutrality rule.

THE U.S. In contrast, one finds neither institutional shareholders nor self-regulation at the heart of U.S. takeover regulation. To understand why, we should begin by revisiting the enactment of the 1933 and 1934 securities acts.

The New Deal reformers believed that the regulatory efforts of the New York Stock Exchange, which was the principal corporate regulator in the early 20th century, were inadequate. The NYSE disclosure requirements were too limited, in their view, and the NYSE too often looked the other way when companies failed to honor the existing rules (similar criticisms to those that would be laid against the first incarnation of the Takeover Panel in 1968). Because of this, and as part of their larger campaign to minimize the influence of Wall Street insiders on American corporate governance, the reformers quite consciously wrested oversight authority away from the NYSE and enshrined it in the securities acts and the rules promulgated by the SEC. Thus, the primary source of securities regulation would be mandatory federal oversight by Congress and the SEC, rather than ongoing self-regulatory adjustments of the sort we see in the UK.

The securities acts also had a subtler geographical effect. One of the factors that have made self-regulation effective in the UK, as we have seen, is the fact that all of the major players are located in close proximity to one another in the City, London's ancient business district. This makes the temporary "secondments" used to staff the Panel much simpler than if the banks and institutions were scattered throughout the country, and it means that the bankers and institutional shareholders rub shoulders on a daily basis. In the United States, visiting all of the relevant players would require trips to Wall Street, Washington and — because directors' fiduciary duties are still regulated by the states — Wilmington and Dover, Del.

The lack of institutional investor influence in the United States meant that although the emergence of hostile tender offers in the late 1950s took corporate America by storm

just as they had in the UK, the political and regulatory dynamics in the States were quite different. The predecessor to the 1968 Williams Act was legislation introduced by Sen. Harrison Williams in 1965 to require incumbent managers to be notified of any stock purchase that exceeds 5 percent of the outstanding shares. His principal concern was not the use of questionable defenses by target managers, but rather the “corporate raiders” and “white collar pirates” that were assaulting “proud old companies” and stripping them down to “corporate shells” by “trad[ing] away the best assets” and keeping “the loot” for themselves.

One might have expected the principal opposition to the proposed legislation to come from institutional shareholders such as pension funds and insurance companies whose stock holdings benefited from the premium prices paid by takeover bidders. Clamping down on tender offers would mean fewer takeover premia. But one searches the legislative history in vain for evidence that institutional shareholders entered the legislative fray. The SEC testified repeatedly and indeed seems to have helped Senator Williams to shape the 1968 legislation. Representatives of the NYSE, the American Stock Exchange, and the National Association of Securities Dealers also testified, as did the Investment Bankers Association of America. Even law and business professors testified. But not one representative of a pension fund, insurance company, or other institutional shareholder took the microphone to offer the perspective of shareholders on the proposed legislation.

Shareholders’ silence surely reflected the fact that, during the same period as UK tax and dividend policy spurred institutional stock ownership, the share of U.S. stock held by institutions remained relatively small. Shareholder voice may also have been chilled by the knowledge that American lawmakers historically had gotten nervous when financial institutions flexed their muscles on corporate governance issues. As a result, the interests of shareholders were represented not by shareholders themselves, but by the SEC.

Because the self-regulatory option had long been foreclosed and the SEC’s role was limited to policing disclosure, the most significant aspects of U.S. takeover regulation are shaped by Delaware judges. Judges can only decide cases that are brought before them. The structure of precedents is therefore influenced by the ability or willingness of particular types of parties to litigate certain types of dispute. The decision to litigate acts as a filter for the evolution of common law rules – or, to put it another way, it represents the “demand side” of common law judicial rulemaking.

Who, then, are the likely litigants in takeover disputes? The defendants will be the target board. While protections such as directors’ and officers’ insurance and golden parachutes often counteract the financial risks, respectively, of personal liability and loss of employment, boards still face significant reputational costs (that is, depreciation of their human capital consequent upon defeat) if they lose a takeover lawsuit, and those costs are far more difficult to insure against. At the same time, because they are able to draw upon corporate resources, boards have deep pockets. This has two impli-

cations: first, boards are likely to be willing to pay over the odds to settle cases; and second, boards will defend aggressively the cases that do go to trial. The target board can settle a stockholder suit for damages, but it cannot do so easily where a jilted bidder seeks an injunction. Most precedents on target boards’ duties have therefore resulted from cases where an injunction is sought.

The bidder’s financial interest lies in the gains to be realized from successfully taking control of the target company, which an injunction may achieve by forcing the target board to drop a defense. Yet an acquirer who succeeds in proving that the board’s defensive tactics are illegitimate will not necessarily capture all of the economic benefits of the judicial ruling. There is nothing to stop a second bidder free-riding on the plaintiff’s efforts and then swooping in on the now-defenseless target company with a higher offer. Given that possibility, the bidder will discount the likely benefits from bringing a lawsuit. This may be expected to result in bidders bringing relatively few suits. The resulting judge-made law may therefore exhibit a pro-management tendency.

Given that using litigation to resolve such matters may involve a structural bias in favor of managers, it should not be surprising that UK institutional investors chose to “privatize” the matter by instituting the Takeover Code in the late 1960s. What is more surprising, however, is that their counterparts in the United States did not. This, as we have explained, is a result of federal legislation that prevented institutional investors from developing sufficiently close links with one another to make collective action on this scale feasible in the United States, together with federal regulation that displaced an earlier tradition of self-regulation in the securities markets. There is an irony, therefore, in calls for federal legislation to remedy the perceived “problem” of Delaware takeover law: in our view, it is federal legislation that is fundamentally responsible for the perceived problem.

CONCLUSION

In both the English and American systems of corporate governance, each of which features dispersed share ownership, the hostile takeover is thought to operate as a disciplinary mechanism for management. Yet both the content of the rules governing the resolution of takeover battles and the way in which the rules are made and enforced are quite different in the two systems. Our analysis has explored the causes of this divergence, and its implications for policymakers.

Critics of the U.S. system have compared it unfavorably to the UK’s takeover regulation and accounted for the difference as flowing from the dynamics of competitive federalism. Our public choice account, in contrast, places the mode of regulation at center-stage in explaining how the differences emerged. Public choice theory implies that legal rules will come to favor the interests of the group(s) with the greatest influence over the rulemaking process. In a system of self-regulation, the groups that have the greatest interest in the regulated activity are likely to organize themselves so as to control the rulemaking agenda. This fits squarely with the fact that British institutional investors,

who for many years have owned the majority of the shares in UK-quoted companies, are the group whose interests have shaped the Takeover Code.

Regardless of how well-informed they are about policy issues, judges can only decide cases that come before them. Thus, in a system where the law is judge-made, the crucial issue is which group is able to exert the greatest influence over the decision to take cases to trial. The structure of bidder and shareholder litigation to enforce directors' duties – for example, in a hostile takeover bid situation – tends to be biased toward the interests of directors, leading the content of precedents to tend to be more favorable to their interests. Our claim that the difference in substance flows from the mode of regulation, as opposed to the existence of regulatory competition in the United States, is reinforced by the fact that the common law of directors' duties in the UK, which is not a federal system, is much closer to the substance of the U.S. model than it is to the Takeover Code.

The question posed by this analysis is why the UK institutional investors were able to "privatize" their takeover regime through self-regulation, whereas their counterparts in the United States were not. The answer to this, we argue, lies in the decades-old legislation that fragmented U.S. financial institutions and vested authority over the markets in the SEC. Congress not only made it more difficult for institutional investors to coordinate, but it directly preempted certain types of self-regulation by stock exchanges. Had it not been for those legal features of the U.S. landscape, we think it likely that institutional investors would have been able to coordinate similarly to their UK counterparts so as to obviate the need for litigation. Given that both the process and substance of the UK's self-regulatory regime are selected and developed by those who have the most at stake in the process, there are strong *prima facie* reasons for thinking it may be superior to that which has prevailed in the United States.

The implications of this for U.S. policymakers are twofold:

On the one hand, the costs of the federal legislation that restricted institutional investor interaction may be significantly more than has been appreciated. At the same time, there is a certain irony in the fact that prominent critics of U.S. takeover law suggest that the solution is to introduce federal legislation along the lines of the UK's Takeover Code. Federal regulation is the explanation for the managerialist U.S. approach, not the solution, in our view.

Our rejection of the "orthodox" explanation for the more manager-friendly U.S. takeover rules, which is based on alleged pathologies of regulatory competition, also has important implications for the growing possibilities for regulatory competition within the EU. Our account, in contrast, does not imply that the UK's takeover regime is likely to be weakened by developing regulatory competition. If anything, we expect its cost advantages to attract, rather than deter, reincorporations.

Finally, the contrast between the U.S. and UK approaches has considerable relevance for emerging economies both in Europe and elsewhere in the world. Reformers have too often assumed that top-down, mandatory regulation, together with the courts, is the only way to regulate corporate transactions in emerging economies. But the success of the UK's Takeover Panel suggests that this assumption is seriously flawed. The U.S. approach requires an effective governmental regulator together with an efficient court system. In many emerging economies, one or both of those elements are missing. In some, the parties that are most directly affected by corporate regulation – large shareholders, banks, and exchanges – are located in close proximity to one another. And they have a direct financial stake in the success of the regulatory framework. In this context, informal self-regulation might prove more effective than the U.S. combination of formal statutes and courts. The UK strategy will not invariably be the best, any more than the approach in the United States. But reformers and lawmakers should keep in mind that there are at least two ways to regulate takeovers, not just one. R

Readings

- "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers," by Ronald Gilson. *Stanford Law Review*, Vol. 33 (1981).
- "Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s," by Bengt Holmstrom and Steven N. Kaplan. *Journal of Economic Perspectives*, Vol. 15 (2001).
- "Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom," by Brian R. Cheffins. *Washington & Lee Law Review*, Vol. 63 (forthcoming 2007).
- "Does Delaware Law Improve Firm Value?" by Robert Daines. *Journal of Financial Economics*, Vol. 62 (2001).
- "European Takeover Regulation," by Erik Berglöf and Mike Burkart. *Economic Policy*, Vol. 18 (2003).
- "Globalizing Corporate Governance: Convergence of Form or Function," by Ronald J. Gilson. *American Journal of Comparative Law*, Vol. 49 (2001).
- "Hail Britannia? Institutional Investor Behavior under Limited Regulation," by Bernard S. Black and John C. Coffee. *Michigan Law Review*, Vol. 92 (1994).
- "Hostility in Takeovers: In the Eyes of the Beholder?" by G. William Schwert. *Journal of Finance*, Vol. 55 (2000).
- "Mergers and the Market for Corporate Control," by Henry Manne. *Journal of Political Economy*, Vol. 73 (1965).
- "Pills, Polls, and Professors Redux," by Martin Lipton. *University of Chicago Law Review*, Vol. 69 (2002).
- "Strong Managers, Weak Owners: The Political Roots of American Corporate Finance," by Mark J. Roe. Princeton, N.J.: Princeton University Press, 1994.
- "The Case Against Board Veto in Corporate Takeovers," by Lucian Ayre Bebchuk. *University of Chicago Law Review*, Vol. 69 (2002).
- "The Disappearing Delaware Effect," by Guhan Subramanian. *Journal of Law, Economics and Organization*, Vol. 20 (2004).
- *The Economic Structure of Corporate Law*, by Frank H. Easterbrook and Daniel R. Fischel. Cambridge, Mass.: Harvard University Press, 1991.
- "The Myth of State Competition in Corporate Law," by Marcel Kahan and Ehud Kamar. *Stanford Law Review*, Vol. 55 (2002).
- "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership," by Henry T.C. Hu and Bernard Black. *Southern California Law Review*, Vol. 79 (2006).