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The EU Takeover Directive and the Competitiveness of European Industry[1]

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CAPITAL AND POWER IN EUROPE

27 years after the first proposal was tabled and fifteen years after real negotiations began, in the spring of 2004 the European Union finally enacted Directive 2004/25/EC of the European Parliament and of the Council on takeover bids[2]. The Takeover Directive sees light after a long and acrimonious journey through the institutional labyrinth in Bruxelles.

The negotiations took so long time because the issue at the heart of the directive, whether hostile acquisitions should be encouraged or whether defences should be allowed, is a proxy for the nature of capitalism at the European level. This is a highly politicized question that divides the EU institutions and the Member States.

MAIN POINTS

As opposed to the Commission proposal, the Takeover Directive agreed by Parliament and Council is good since it allows different types of comparative advantage to coexist. There is a risk this could change since the Continental-Nordic model is defined as an exception to an Anglo-American default condition.

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The Commission and the UK, on the one hand, proposed to use the Takeover Directive as a tool to open companies to the market for corporate control by outlawing defences against hostile acquisitions, aiming to create a liberal variety of capitalism, which privileges minority shareholders – such as institutional portfolio investors – over blockholders, management, and workers.

The Parliament and many Continental-Nordic Member States, on the other hand, fought against this proposal, recognizing that hostile acquisitions would undermine the operation of the non-market institutions that underpin the industrial competitiveness of their coordinated variety of capitalism, which acknowledges a number of stakeholders as constituencies with a say over corporate governance.

Given the long-standing institutional differences between the different varieties of capitalism at the national level (Hall and Soskice, 2001b) and the great power that the governments of the Member States have in shaping the course of European integration to suit their distinct national interests (Moravcsik, 1999), it proved extremely difficult to reach agreement on a common European solution.

In the last few years, this battle over the future shape of European capitalism focused on two particular articles in the proposal for a directive presented by the Commission. Article 9 outlaws post-bid defences against hostile bids by obliging the board of directors of target companies to remain neutral and not take any actions that could frustrate the bid. Article 11 enables the hostile bidder to break through pre-bid defences such as multiple voting rights and other measures that distribute control rights disproportionate to cash-flow rights.

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1 This paper is based on research in progress for a doctoral dissertation at the University of Oxford (Nilsen, forthcoming).

2 On April 21, 2004, the directive was signed by the Council and the Parliament. On May 20, 2004, it came into force. The Member States must transpose it into national law before May 20, 2006.

In the compromise that eventually was reached, Article 12 makes both Article 9 and Article 11 optional. All in all, this is a good solution that enables Member States with different types of market economies to preserve their unique comparative advantages, promoting a more competitive Europe as a whole.

THE RECENT HISTORY OF THE EU TAKEOVER DIRECTIVE

Although the idea to regulate takeovers on the European level emerged already in 1977, it was not taken seriously until it was included in the 1985 White Paper on the Internal Market and it did not start to make headlines until much later.

The recent history of the directive has been fairly dramatic by Bruxelles standards[3]. Some heated days in the summer of 2001 saw Germany outvoted in a qualified majority decision in the Council, followed by agreement under the co-decision procedure between the Council and Parliament in the so-called Conciliation Committee to adopt the Commission's proposal, which to everybody's surprise was rejected by a tied 273-273 vote in the Parliament following a remarkable mobilization of German MEPs by the German government[4].

After this unexpected setback, the Commission established a High Level Group of Company Law Experts, the Winter Commission, with the

3 An overview of the key developments in the last few years with links to the main political and legal texts can be found at http://europa.eu.int/prelex/detail_dossier_real.cfm?CL=en&DosId=176750.

4 On June 19, 2000, the Council adopted its common position. In late 2000, the Parliament adopted amendments. In early 2001, the Council rejected some of the amendments. On April 10, 2001, the conciliation procedure was initiated. On June 6, 2001, a compromise text was agreed by the Conciliation Committee – reportedly at 00.45 in the middle of the night. On July 4, 2001, the compromise text was rejected by the Parliament.

main task of paving the way for a new directive proposal that would address the concerns of the Parliament[5]. Based on the Winter report, the Commission in the spring and summer of 2002 prepared a new directive proposal[6]. The new text introduced a procedure for a squeeze-out right and a sell-out right, a definition of the equitable price to be paid in case of a mandatory bid, rules aiming to establish a level playing field, and a clarification of the rights of employees.

Frits Bolkestein, the Internal Market Commissioner, realized that taking on Germany was too big a battle and changed his strategy in the new proposal to target Sweden and the other Nordic countries instead. The most controversial proposal was expanding the scope of Article 11 to outlaw multiple classes of common stock carrying different voting rights, which is a common arrangement of corporate financing in these countries and an important foundation of corporate governance in some of their leading companies.

Following intense lobbying by the Wallenberg family and the rest of the Swedish establishment in 2003, gaining sympathy from other Member States who feared they might be next in line to be targeted, Bolkestein was finally defeated. In the winter of 2003, the Council and the Internal Market and Legal Affairs Committee of the Parliament agreed to a compromise proposal crafted by the Italian Presidency and Rapporteur Klaus-Heiner Lehne[7].

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[5] The Winter Commission was established on September 4, 2001, met for the first time on September 11, 2001, and presented its report on 'Issues Related to Takeover Bids' on January 10, 2002.

[6] The new proposal was presented on October 2, 2002.

[7] On November 27, 2003, the Council and the Parliament agreed to the compromise proposal. This was confirmed on December 16, 2003, by the Parliament in an opinion, on December 22, 2003, by the Council in the form of a political agreement, and on March 30, 2004, by the Council giving its formal approval.

The Council-Parliament agreement essentially turned the Commission proposal up-side-down by introducing an Article 12 which makes the contentious Article 9 (on neutrality) and Article 11 (on breakthroughs) optional[8]. In the spring of 2004, the European Union adopted this compromise as the Takeover Directive, eventually equipping Europe with a common legal framework for the regulation of takeovers[9].

THE COMMISSION PROPOSAL – A THREAT TO THE COMPARATIVE ADVANTAGE OF EUROPE

The objective of the Commission with regards to the Takeover Directive was to open companies to the market for corporate control by outlawing defences against hostile acquisitions.

The underlying idea, based on Chicago school economics, is that the constant threat of a hostile acquisition in a free market for corporate control will discipline management, leading to enhanced corporate performance and overall economic growth.

The Takeover Directive was also one of ten priorities outlined in the Financial Services Action Plan for the creation of a fully integrated market in financial services, which is one of the last remaining areas in the process of completing the Single Market.

The Commission therefore hoped to outlaw both pre-bid and post-bid defences against hostile acquisitions in one go through the directive. The

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8 The optional nature of Article 9 and Article 11 is very complex. While Member States may opt out, individual companies might opt back in. As if that was not enough, these companies might opt back out again if they are faced with bid from company that does not follow similar rules.

9 On April 21, 2004, the directive was signed by the Council and the Parliament. On May 20, 2004, it came into force. The Member States must transpose it into national law before May 20, 2006.

plan was to achieve this by means of two key articles. Article 9 prohibits post-bid defences against hostile bids by obliging the board of directors of target companies to remain neutral and not take any actions that could frustrate the bid. Article 11 enables hostile bidders to break through pre-bid defences such as multiple voting rights and other measures that distribute control rights disproportionate to cash-flow rights[10].

If the original Commission proposal had been adopted by the Council and Parliament, it would have opened all companies in Europe to the market for corporate control by outlawing defences against hostile acquisitions.

This would have strongly contributed to create a liberal rather than a coordinated variety of capitalism at the European level[11]. That would not have required any fundamental change in Member States that already had liberal market economies, such as the UK and Ireland. However, it could have forced systemic change in Member States that instead had coordinated market economies, such as Germany and the Nordic countries.

The reason is that the threat of hostile acquisitions would most likely destabilize the operation of the non-market institutions that underpin coordinated market economies (Hall and Soskice, 2001a: 61). Takeovers lead to higher uncertainty and breaches of commitments, which erodes trust, shortens the time horizon, and makes cooperation hard to sustain.

Moreover, since corporate governance is at the heart of the economic system, connected to the systems that provide companies with capital,

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[10] Equitable compensation would have to be provided to anyone who thereby lost any rights.

[11] Nilsen gives a detailed account of the political economy of takeovers from the perspective of different varieties of capitalism with different models of corporate governance (Nilsen, 2004).

technology, labour, and skills through institutional complementarities, a fundamental change in the arrangements for corporate governance would most likely have spilt over into the other spheres.

The original Commission proposal was a threat to the comparative advantage of Europe for a number of reasons.

First, a systemic change in coordinated market economies would have undermined their distinct comparative advantages, based on incremental innovation, highly skilled workers, and quality differentiation, while not ensuring that they would develop the different comparative advantages of the liberal market economies, based on radical innovation, flexible labour markets, and cost differentiation (Nilsen, 2002).

Second, O'Sullivan questions whether the idea that the threat of hostile acquisitions disciplines management is true even in liberal market economies (2000: 169). The effects of takeovers in fact seem to be either ambiguous or negative. It is uncertain whether the investment returns to the shareholders of target companies are unusually low before a bid (Ravenscraft and Scherer, 1987; Morck, Shleifer, and Vishny, 1988; Franks and Mayer, 1996). With regards to the investment returns after a bid has been finalized, both Ravenscraft and Scherer (1987) and Herman and Lowenstein (1988), find that they decrease. O'Sullivan draws the conclusion that, 'with a few exceptions, most empirical studies of post-acquisition performance have failed to provide strong evidence of the disciplinary role of takeovers and some have even suggested that the market for corporate control reduces economic performance' (2000: 169)[12].

Third, there are also a number of problems at the technical level that applies to both coordinated and liberal market economies. In particular,

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[12] Charkham explains that there are many plausible reasons for takeovers that have nothing to do with disciplining management, such as non-organic growth, protection against takeovers, diversification, increase in market share, and expansion into new markets (Charkham, 1994: 303-305).

Article 11 (on breakthroughs) would seem to produce some unintended adverse effects even in liberal market economies. The reason is that it could be construed to render invalid a number of normal business practices. One example is the dual listed company structures used in certain mergers, which includes specific arrangements to ensure that the votes of one company are reflected at the general meeting of the other and that one company cannot be taken over unless an offer is also made for the other company. Another example is provisions in stocklending arrangements, put and call options, and the grant of security over shares. (http://www.herbertsmith.com/uploads/HSpdfs/LC_takeover_briefing_June2004.pdf).

THE COUNCIL-PARLIAMENT AGREEMENT – A TICKING BOMB?

In the compromise that eventually was reached, Article 12 makes both Article 9 and Article 11 optional. All in all, this is a good solution that enables Member States with different varieties of capitalism to preserve their unique comparative advantages, promoting a more competitive Europe as a whole.

However, it may not be a stable solution. The fact that the Continental-Nordic option is included just as an exception in a directive that establishes the Anglo-American option as the default condition is worrying. Exceptions are, by their very nature, vulnerable to being removed at a later stage. It would have been much better with a directive that presented the two options on an equal level without an implicit bias in favour of one and against the other.

This is of particular concern since we cannot assume that the Commission has simply given up its ambitions. Several of the key economic portfolios in the new Barroso Commission have been handed to free-market liberals. This includes Bolkestein's portfolio, which has been given to Charlie McCreevy.

The Commission also has an impressive capacity to eventually get its way despite resistance and setbacks. Previously, the Commission has successfully used its longer time horizon in policy-making relative to that of the Member States to incrementally increase biases in favour of its own position over time. By the time most of the Member States notice that their desired solution has been virtually eroded away, it is often too late. Another sophisticated strategy is to encourage Court actions that by striking down some of the available options move the positions of some of the Member States closer to that of the Commission. The current attempts to outlaw the Volkswagengesetz, for instance, could have serious ramifications for the German position.

It should be noted that the Commission's future strategy with regards to the Takeover Directive must be assessed in the broader perspective of their views on corporate governance more generally. In this regard, the Prodi Commission was internally divided. While the Internal Market Directorate-General pursued shareholder capitalism through the initial proposal for a Takeover Directive, other Directorate-Generals introduced initiatives such as the European Company Statute that were more favourable to stakeholder capitalism.

It is to be hoped that McCreevy shows a more sophisticated understanding of the diverse foundations of comparative advantage in different Member States than Bolkestein did. The Barroso Commission should abandon the quest for a single European market for corporate control. It should instead let the Continental-Nordic Member States keep their takeover defences since they are vital to protect the non-market institutions that sustain their comparative advantage. This would also ensure a coherent regulatory framework of corporate governance on the European level, where the Takeover Directive and the Company Statute continue to complement each other.

If not, the Takeover Directive could be a ticking bomb that threatens the future competitive advantage of business and industry in Europe.

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