Corporate Takeovers And Shareholder Protection: UK Takeover Regulation In Perspective

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Abstract

This article examines the regulatory framework for shareholder protection during takeovers in the UK. It is aimed at ascertaining the extent that takeover regulations protect shareholders from company managements who may pursue objectives that are different from enhancing shareholder value. Pursuant to this, a narrative of the historical development of takeover regulation in the UK is provided to show why takeover regulation emerged. Using doctrinal legal analysis, the current takeover regulations The EU Takeover Directive [2004] and The City Code on Takeovers and Mergers (as amended in 2011) are examined. It emerged that these regulations were developed to protect only the shareholders of acquired companies. While this represents an improvement towards shareholder protection, the essay argues that the regulations do not provide a complete protection to shareholders of target companies as managements may promote their own interests using pre-bid defences. Aspects of directors' duties were examined to fill the regulatory gaps in this regard, but the duties appear not to provide any remedy to shareholders, since they do not specifically apply to takeovers. Further, in the absence of a specific regulation for protecting shareholders of acquiring companies, the derivative action procedure was examined as an alternative form of remedy. But since derivative actions are based on wrong done to a company, it is difficult for shareholders to rely on this. Thus, apart from strengthening the current takeover regulations that protect the shareholders of acquired companies, it is also imperative that a framework for protecting the shareholders of acquiring companies should be developed.

I. Introduction

The main objective of a company as a going concern[1] is to enhance its economic values through strategic investment decisions of its management team. Generally, an improvement in the economic value of a company is largely dependent on the extent to which the investments of its individual investors or shareholders are actually enhanced. A corporate takeover is one of the ways of enhancing the economic value of a company. It involves an auction in which prospective investors - usually a company - bid for the right to obtain control of another company.[2] A successful bid leads to a combination of the assets of the acquiring and the acquired companies, thereby leading to a higher economic value of the combined company than the individual values of the separate companies before the acquisition. But, the extent to which takeovers operate to promote the values of shareholders is unclear. Takeovers have different functions, including its disciplinary role[3] and synergy gains.[4] Takeovers may also lead to hubris,[5] when management pursue acquisitions that lead to an expansion of the corporate size, without corresponding economic gains to

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1 'Going concern' is the ability of a company to make enough money so that it can continue to do business and avoid bankruptcy.

2 For a definition of takeovers, see: Nikhil P Varaiya, 'The 'Winner's Curse' Hypothesis and Corporate Takeovers' (1988) 9 Managerial and Decision Economics 209, 210.

3 Takeovers are a disciplinary tool for a poorly performing management board of a company. Often, a takeover leads to the dismissal of company managements of acquired companies who have failed to improve the performance of their companies, thus making their companies to be easy targets for takeovers. See: Richard A Brealey, Stewart C Myers et al, *Principles of Corporate Finance* (McGraw-Hill/Irwin New York 2008) at 887.

4 Takeovers have synergistic functions; they lead to a combination of the assets and operations of the acquired and acquiring companies. See generally: Lynn Hodgkinson and Graham L Partington, 'The Motives for Takeovers in the UK' (2008) 35 JBFA 102.

5 Takeovers may not lead to any economic gains to the acquired company, possibly caused by paying too much (over-payment) to acquire a company, which often leads to losses or zero-gains to the acquiring companies. See, Richard Roll, 'The Hubris Hypothesis of Takeovers' (1986) 59 JBF 197.

the company. The importance of these functions depends on whether a company is an acquiring company or a target company. While takeovers remain an important aspect of the market for corporate control,[6] company managements have largely played a central role in takeovers.

The relationship between company management and shareholders has been described as one of agent and principal respectively.[7] This relationship often gives rise to a conflict of interests, especially during takeovers. While management may be interested in retaining their positions in the company and extending the size of the company through acquisitions, shareholders are actually interested in an increase in the value of their shares. In recognition of these challenges, directors' duties have now been codified to generally enhance levels of accountability.[8] Also, the derivative action procedure provides an opportunity for shareholders to hold their company management to account for their role in enhancing the interest of the company.[9] More specifically, takeover regulations have been developed that seek to limit the extent to which company management influences the outcomes of takeovers.[10] However it remains doubtful whether the objectives of the codified duties of directors, derivative actions and takeover regulations have achieved these aims.

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6 Corporate control includes measures through which the role of company managements is influenced. It has been suggested that the market for corporate control serves as an alternative means for enhancing the performance of company management where the internal control and corporate governance measures fail. See Henry G Manne, 'Mergers and the Markets for Corporate Control' (1965) 73 JPE 110, 112-120.

7 Shareholders as principals appoint the company management to manage the business as agents. See generally: Michael C Jensen, & William H Meckling 'Theory of the Firm: Managerial Behaviour, Agency Cost and Ownership Structure' (1976) 3 JFE 305.

8 Companies Act 2006 ss 171-177.

9 See Companies Act ss 260-269.

10 Council and European Parliament Directive 2004/25/EC of 21 April 2004 on Takeover Bids [2004] OJ L142/12 ('The Takeover Directive'), and The UK City Code on Takeovers and Mergers 2013 ('The Takeover Code').

In view of this, this paper examines corporate takeover regulation in the United Kingdom with a particular reference to shareholder protection. The objective here is to ascertain the extent to which the interests of the shareholders of the target and acquiring companies are effectively protected during takeovers. In section two, a brief historical development of takeovers in the United Kingdom will be highlighted. This is aimed at ascertaining the relationship between corporate managements and company shareholders during the takeovers that triggered the emergence of takeover regulation. Section three examines the extant takeover regulation in the United Kingdom. The combined effects of the Takeover Directive and the Takeover Code will be evaluated with particular reference to shareholder protection during takeovers as it affects shareholders in the target and acquiring companies. The duties of company directors under the Companies Act 2006 will be examined in section four. While these duties are not particularly directed at takeovers, they nevertheless describe the acceptable standard of behaviour that directors should conform to when executing their general functions. The extent to which company shareholders can effectively hold management to account for decisions that are made pursuant to takeovers through derivative actions will also be examined. Afterwards, section five concludes the paper.

II. Historical Development of Takeover Regulations in the United Kingdom

Corporate takeovers in the UK have been a recurrent phenomenon from the early 1950s to recent times. Throughout these periods, takeovers have been fuelled by the desire of external investors to acquire and invest in companies which they believe could be better run to achieve a more desirable economic value than the present output of

the current managers.[11] Whilst the current management of a target company may become an obstacle to achieving this aim, this could be overcome by the dissatisfaction of the shareholders. Often, shareholders view the interests of external investors in acquiring their companies as an avenue to divest their holding and, more importantly, to profit from their investments in light of unfavourable investment decisions of their company managements. These considerations influenced the first successful takeover in the UK in 1953.[12] The shareholders of the company felt short-changed because the value of their investment was reflected not in the share price, but on dividends, and the rate of dividend payments was substantially low when compared to the company's profit margin. Consequently, a majority of shareholders at that time ignored promises made by the board to increase the rate of dividend and sold their shares to the investor, leading to what became the first successful corporate takeover in the UK.[13]

Later in the same year, investor Harold Samuel sought to acquire *Savoy Hotel Ltd.* The intention of the investor was to acquire the hotel and convert it to office premises. The management of the company were opposed to the takeover attempt and this led to a conflict that involved the management, the shareholders and the investor. The shareholders were disappointed that the management opposed the takeover bid and so they sought to sell their shares to the investor. However, to prevent the company from being acquired by the investor, the management of *Savoy Hotel* arranged for the hotel property to be sold to

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11 Ronald W Moon, 'Business Mergers and Takeover Bids: A Study of the Postwar Patterns of Amalgamatons and Reconstruction of Companies' (Gee & Co, 1976) at 9-10.

12 The 'J Sears Holdings' Later acquired by *Charles Clore*.

13 A similar tactics used by the board of a company that was a takeover target by *Charles Clore* had earlier been successful. See John Armour and David A Skeel Jr, 'Who Write the Rules for Hostile Takeovers and Why? - The Peculiar Divergence of US and UK Takeover Regulation' (2006-2007) 95 The George Town Journal, 1727 at 1757 (fn 125).

Worcester (London) Co. Ltd. The company management made an agreement with the new company that the hotel should be leased back to them - the current management - on terms that the property should only be used for the purposes of a hotel business and not be converted into offices. This effectively frustrated the takeover attempt of Harold Samuel. The decision of the hotel management was made without reference to shareholder interest and this infuriated them further since they were powerless to change this decision.

Public concern led the Board of Trade to investigate the conduct of the directors, but as the report of the Board was not binding, company boards had an air of invincibility during takeovers.[14]

Conflict of interests during takeovers reached its peak when two different investors, *Reynolds Metal Company* in partnership with UK-based *Tube Investments ("TI-Reynolds")* and *Aluminium Company of America (ALCOA)* sought to acquire *British Aluminium Ltd.* The board of *British Aluminium* accepted the bid of one of the bidders and offered them a third of the shares in the company without the approval of their shareholders. The shareholders only became aware when the rival bidder informed the management of their intentions to deal with shareholders directly, and in an attempt to placate the shareholders the board offered to increase dividend payments, leading to an increase in shareholder value.[15] However, the shareholders became even more infuriated in view of the fact that the deal that the board had made with the other bidder was concluded at an undervalued price. This prompted shareholders to dispose of their shares to the rival bidder in anger. This sparked a widespread call for takeover regulations based on certain takeover principles,

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14 ibid, 1757, citing 'Battle for the Savoy' *The Economist* (London, 12 December 1953).

15 ibid 1758 citing 'Dividend Raised to Counter Bid' *The Times* (London, 20 December 1958) 6.

such as board neutrality and shareholder primacy.[16] This led to the humble beginning of takeover regulation.

The historical development of takeovers in the UK revealed that company managements and their shareholders consistently disagreed during takeovers. It also revealed that managements have the capacity to determine the outcomes of takeovers independently of shareholders since as they occupy positions of authority that enable them to determine whether a takeover bid is accepted or rejected. However, it is arguable as to whether managements act in pursuit of their personal interests or for the interests of the company. Usually, a board may oppose a takeover bid to encourage the bidder to increase their offer. They may oppose bids to signal to the market that a bid has been made and encourage other bidders leading to a price war for the company.[17] These are clear examples of managements pursuing the interest of the company, particularly those of the shareholders. But this is not always the case. Management may oppose bids for fear of losing their positions. They may oppose a bid even where there are economic benefits that could be derived by the shareholders of their company. However, irrespective of the objective of the actions of management during takeovers, it is imperative that shareholders are actively involved in decisions leading to the outcome of a bid. The early period of takeovers was characterised by managerial decisions that disregarded the input of shareholders, even though their shares were the subject matter of takeovers. Consequently, it became imperative that shareholders must be protected from managerial excesses, meaning that takeover regulation was introduced to protect the interests of shareholders.

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16 ibid 1759.

17 Thomas W Bates and David A Becher, 'Bid Resistance by Takeover Targets: Managerial Bargaining or Bad Faith? (2011) Chicago Meetings Paper, AFA/2012 1-49 at 29 <http://dx.doi.org/10.2139/ssrn.1786674> accessed 11 April 2013.

After the introduction of the regulation of takeovers in 1968,[18] it continues to be a prominent feature of the life of companies as a going concern, and it has indeed become an important function of the market for corporate control. Despite the existence of takeover regulations, the conflict of interests that characterised the relationship between corporate management and their shareholders during the early periods of takeovers remains a challenge. Although, the powers of management during takeovers have been reduced, they still possess significant discretionary powers that are capable of undermining the objectives of takeover regulation.[19] Thus, the extent to which the takeover regulations can effectively prevent company managements from promoting their personal interests during takeovers is largely unclear. The next section examines the extant takeover regulatory mechanisms.

III. Shareholder Protection under the EU Takeover Directive and the UK City Code on Takeover

The events stated above led to demands for takeover regulations, which at the core contained the principles of shareholder protection and board neutrality.[20] The regulation took the form of the City Code on Takeovers and Mergers. This was supplemented with the EU Takeover Directive in 2004, which regulated takeovers within the EU. Thus takeovers in the UK are regulated by the combined effect of both sets of regulations. These restrict the roles of company management during takeovers to ensure that shareholders are not denied the opportunity of deciding on

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18 The Takeovers Code is administered by The Panel on Takeovers and Mergers.

19 This discretionary powers can be used as takeover defences measures, especially where management are not favourably disposed to a takeover bid.

20 The *board neutrality principle* and *shareholder primacy* is meant to ensure that the management board of target companies do not use their positions of authority to influence a takeover bid. They are to ensure that the shareholders of their companies give prior approval to their decisions concerning a bid. See the UK Takeover Code 2013, *General Principles B1* (3); The Takeover Directive, Art 9 (2).

the merits of a takeover bid. Although these regulations promote the interests of company shareholders during takeovers, they have a restricted scope of application. This gives room for corporate management to unduly interfere with takeovers at the expense of the interests of their shareholders.

The other issue is that, despite takeovers involving both the acquiring and target companies, debate on takeover regulations has largely considered the effect on shareholders and the conduct of the management of the target company. This has been at the expense of considering takeovers from the perspective of the acquiring company, especially their shareholders. In light of this, the extent to which shareholders are protected from managerial excesses during takeovers will be discussed from the perspective of both target and acquiring companies. In pursuance to this, the combined effects of the EU Takeover Directive and the UK City Code on Takeovers will be examined.

A. Shareholder Protection in Target Companies

Largely, the scope of shareholder protection appears to be restricted to the shareholders of target companies. This can be deduced from the principal objectives that underlie the EU Takeover Directive[21] and the UK City Code on Takeovers.[22] Under these regulations, the management of target companies are prevented from making any decision that is capable of indicating that a takeover bid has been accepted or rejected by the company without the approval of the shareholders of the company.[23] The essence of this non-frustration rule is to prevent managements from doing

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21 The Takeover Directive, Art 3 *(General Principles)*.

22 The purpose of the code is indicated to protect the shareholders of the offeree (target) company: 'The Code is designed principally to ensure that shareholders in an offeree company are treated fairly and are not denied an opportunity to decide on the merits of a takeover and that shareholders in the offeree company of the same class are afforded equivalent treatment by an offeror.' See: Nature and Purpose of the Code, Introduction 2 (a).

23 The Takeover Directive, Art 9 (2 & 5), The Takeover Code, rule 21.

anything that will discourage a bidder from continuing with a takeover attempt without the authority of shareholders. Managements are meant to play advisory roles only in the determination of whether a takeover bid should be accepted or rejected by the company. While this represents the objective of the regulatory functions of takeovers, it remains to be seen whether this objective can be achieved in light of the operative provisions of the regulatory mechanisms. Management can actually 'go round' the restrictions contained in takeover regulations to enhance their own objectives in the following ways.

Firstly, managements are required not to conduct themselves or carry out any action that may enhance or mitigate the chances of a bid, they are also required not to carry out any positive action towards enhancing the interest of shareholders, other than making available competent independent advice on the fairness of a bid.[24] As such, they may misrepresent the true state of affairs and mislead shareholders based on advice provided in bad faith. But, they are not likely to be held responsible for any unpleasant outcome based on such advice.[25] While it may not be inferred that company management deliberately refuses to promote the interests of their shareholders during takeovers, the fact that management are keenly interested in the outcome of a takeover bid[26] provides a sufficient reason to supervise their role during takeovers. But since their opinion regarding a takeover bid is not subject to any external review, and their shareholders are highly likely to rely on their opinions, they may subtly influence the outcome of takeovers.

Secondly, the non-frustration rule of takeovers, which restricts the role of management during takeovers, may

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24 The Takeover Code, rule 3 (1).

25 Blanaid J Clark, 'The Takeover Directive: Is a little Regulation Better than No Regulation?' (2009) 15 ELJ 174 at 188.

26 Managements are interested in the outcome of takeover bids because they are likely to be dismissed post-takeover.

not effectively prevent takeover bid defences, especially pre-bid defences. This rule adds nothing to the existing obligations of directors, since they are already required under company law to act in good faith in fulfilling their obligations.[27] In anticipation of the restrictive roles which company management are expected to play during takeovers for which they are aware, they can devise a means of limiting the extent to which the rule applies to them. Since the non-frustration rule only applies when takeover bids have been made, certain pre-bid defensive mechanisms can be adopted by the board that take effect when a takeover bid is made.[28] These include lucrative compensation packages based on contracts of employment, which serve to compensate company management should their positions be terminated by a change of control. This operates to make a takeover more expensive for the offeror, as they would incur the cost of these compensation packages. Also, a staggered board appointment procedure[29] or dual class voting stock[30] may be adopted. Although most of these measures appear to have been largely restricted by corporate governance principles[31]

27Paul Davies and Edmund-Philip Schuster et al, 'The Takeover Directive as a Protectionist Tool' (2010) ECCG Working Paper Series in Law 141/2010, 1 at 4. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1554616> accessed 10 April 2013.

28 See particularly: The Takeover Directive, introductory paragraph 2, and Article 9, Rule 2; UK Takeover Code B1 General Principles 3 see also: William Magnuson, 'Takeover Regulation in the United States and Europe: An Institutional Approach' (2009) 21 PILR 205 at 221.

29 Staggered boards procedure prevents a bidder from gaining immediate control of the board of directors of the target company if the takeover is successful. It discourages a bidder from continuing with a takeover. See generally; Lucian A Bebchuk, John C Coates IV & Guhan Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy' (2002) 54 SLR 887.

30 Dual class voting stocks frustrates takeovers. Two or more classes of shares may be created by a company. While one class (class A) can be publicly traded and carries a single vote per share, another class (class B) is not publicly traded and may carry as much as five or ten votes per share. Thus when there is a threat of a takeover, the holders of class B shares would have enough votes to defeat the takeover bid.

31 Shareholders' approval is required to issue new shares and dual-class voting stock is largely unsupported by institutional shareholders.

and company law,[32] they may not be effective to actually restrict pre-bid managerial-entrenchment practices since they operate to only regulate the relationship between company shareholders and management as principal and agents respectively.[33] The need to develop specific takeover regulations is indicative of the fact that the effectiveness of company law and corporate governance principles in regulating takeovers and restricting the role of management cannot be guaranteed.

Furthermore, since companies are required to disclose the identities of owners of shares which carry voting rights after a takeover bid has been made,[34] they are usually allowed a certain period of time after a bid has been made to collate and document such information. This has the side effect of granting extra time to company managements to explore more defensive means to subtly frustrate a takeover bid.[35] For example, the management can solicit 'white knights'.[36] Although this is not explicitly forbidden by the rules, the mere invitation by management may effectively mean that they are interfering with the takeover bid. Nevertheless, an invitation may be justified in view of the fact that their participation in takeovers operates to promote competition, which may enhance the value of the bid. In fact, when a bid has been announced and made public, other bidders may become interested in acquiring the target company as well. In either case, bid prices are likely to rise as competition amongst bidders intensifies. Thus any attempts to prevent or discourage managements from inviting 'white knights' to become involved in the bid process could

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32 Staggered boards mechanisms are rendered ineffective in view of the fact that shareholders can remove directors at anytime. See Companies Act s 168.

33 Reinier Kraakman and John Armour et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP, 2009) at 247.

34 Apparently to prevent false markets, see The Takeover Directive, Article 8.

35 Kraakman and Armour (n 33) 236.

36 Han W Liu 'The Non Frustration Rule of the UK City Code on Takeovers and Mergers and Related Agency Problems: What are the Implications for the EC Takeover Directive?' (2010-2011) 17 CJEL, 5-10 at 9.

have an adverse effect on the competitive nature of a bid. Also, it would be difficult to establish whether a rival bidder has been invited by management or whether a rival bidder was genuinely introduced as a result of the bid announcement.

The emergence of takeover regulation has largely restricted the scope of the powers of managements during takeovers. Shareholders now have an active role particularly with reference to deciding whether to accept a bid on its merit. But since management may find a way to subvert these protective measures through their advisory roles and pre-bid defences, it appears that takeover regulations have not effectively restricted the managements of target companies from interfering with takeover bids. To provide effective protection to shareholders of target companies, a further restriction and supervision of the roles of managements during takeovers is required. However, further restrictions on the roles of managements during takeovers may interfere with their ability to perform their functions as agents of the shareholders. Thus it is important to provide the needed balance between preventing company managements from interfering with the interests of their shareholders during takeovers and allowing them to perform the functions that they owe to their company and the shareholders. In light of this, the shareholders may rely on the general duties of directors to make managements more accountable.[37] But whether company shareholders can actually rely on these duties during takeovers is unclear and this will be examined in section four.

B. Shareholder Protection in Acquiring Companies

As stated above, the regulatory mechanisms on takeovers mainly focus on protecting the interests of the shareholders of target companies. However, during takeovers, the economic interests of the shareholders of

37 Companies Act, ss 171-177.

acquiring companies are also affected as the benefit that they derive from takeovers depends on the net economic value of their investment following the takeover.[38] Usually, whether the economic interests of shareholders are enhanced post-takeover depends on the underlying motive of the particular takeover. Since takeovers form part of investment decisions of corporate management, the decision to acquire another company should be based on the economic benefits that should accrue to the combined company post-takeover.

The inherent conflict of interests between directors and shareholders in acquiring companies means that the extent to which corporate acquisitions enhance shareholder value of the acquiring company remains contentious. As decisions to engage in takeovers are not specifically regulated, with only the broad duties on a board to operate the company with the shareholders' interests applying, a board can take advantage of their position at the expense of their shareholders. Firstly, a board may be driven by the desire to enlarge the size of the company that they control, to enhance the value of their positions and for the purpose of prestige among other reasons.[39] Also, they may pursue acquisitions as a pre-bid takeover defensive mechanism, undertaken by management fearing being acquired themselves, because takeovers which lead to the expansion of the acquiring company, make that company less likely to be a target of a takeover itself.[40]

Where acquisitions made by corporate managements are not driven by any of the above factors, it is expected that such acquisitions would invariably lead to gains for shareholders of acquiring companies. When this is not the case, it is difficult to determine the actual motive of management in their decisions to pursue acquisitions. When

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38 Roll (n 5) at 201-03.

39 Michael Firth, 'Corporate Takeovers, Shareholder Returns and Executive Rewards' (1991) 12 MDE 421 at 425-27.

40 See generally: Gary Gorton Matthias Kahl, and Richard J Rosen, 'Eat or Be Eaten: A Theory of Mergers and Firm Size' (2009) 64 TJF, 1291.

an acquisition fails to confer benefits on shareholders, it may be caused by managerial overestimation of the synergistic gains that were expected from such acquisitions, leading to payment of higher bid premiums than necessary.[41] Although the hubris hypothesis does not suggest that management deliberately pay too much, the fact that management fail to diligently focus on realistic gains by being overconfident, may suggest that they deliberately made such acquisitions based on a motive which is different from the pursuit of shareholder value.[42] The effect of such acquisition is a transfer of wealth from the shareholders of the acquiring company to the shareholders of the target company. Where such decisions are not deliberate, they are likely to have been negligently made, especially as management suffers no loss in any event. Hence it was argued that managements that wish to maximise their private benefits bid for larger targets and pay premiums that are greater that the values of synergies. Whereas managements that are more concerned with enhancing shareholder value would seek smaller targets with which they can achieve corporate synergies.[43]

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41 Managerial hubris. See generally Roll (n 5).

42 Ulrike Malmendier and Geoffrey Tate, 'Who Makes Acquisitions? CEO Overconfidence and the Market's Reaction' (2008) 89 JFE 20-43 at 36-42.

43 Paul Draper and Krishna Paudyal, 'Acquisitions: 'Private versus Public' (2006) 12 EFM 57 at 73. See also, Mara Faccio, John J McConnell, and David Stolin, 'Returns to Acquirers of Listed and Unlisted Targets' (2006) 41 JFQA 197.

Table III (b)

		High relative size ratio			Low relative size ratio			
	Holding period	Cash	Shares	All	Cash	Shares	All	dummy
All bidders	Pre-event	0.8545	1.0707	0.7332	0.2850	1.5101	0.5077	0.3542
	Around event	0.3550	1.4077	0.4513	0.8704	-0.5477	0.9376	-0.4683
	Post-event	0.7165	1.5160	0.4106	0.4906	0.1729	0.3904	-0.0225
	Entire event	1.9496	6.0820	1.7428	1.7394	1.4935	2.0543	-0.0283
	N	2685	267	4271	1943	450	4271	8542
Bidders for listed firms	Pre-event	0.1175	0.6900	0.1582	-1.1349	2.2520	0.2448	0.1179
	Around event	-0.5408	-0.5590	-0.0691	-0.0556	-2.6681	-0.5273	0.4065
	Post-event	0.3232	-2.9590	-0.2283	-0.1679	-0.2587	0.1441	-0.4507
	Entire event	0.3198	-2.0170	0.0425	-1.3696	-0.3940	-0.0908	0.1509
	N	214	16	344	237	174	745	1089
Bidders for private firms	Pre-event	0.9068	1.0919	0.7542	0.4748	0.9609	0.5626	0.3332
	Around event	0.4346	1.4930	0.5011	0.9993	0.6835	1.2578	-0.7261
	Post-event	0.7425	1.8410	0.4483	0.5883	0.3497	0.4504	-0.0219
	Entire event	2.0956	6.6230	1.8594	2.1698	2.7430	2.5259	-0.3180
	N	2471	251	3927	1706	276	3526	7453

Table III (b) [44] indicates that the acquirers of large targets (listed firms) fail to gain from the announcement of bids while the acquirers of privately held companies (small companies) benefit significantly. This is less likely to occur if management invested in their companies, as they would then have an incentive to take more care in making investment decisions. [45] Generally, managements have a duty to promote the interests of a company; and this is often indicated by its share price, payment of dividends and profits, meaning that managements are expected to make decisions that promote these objectives and other corporate values.

In summary, it appears that takeover regulation, designed to curb managerial excesses, has not completely achieved the desired objective of promoting shareholders' interests. This is particularly obvious when considering the shareholders of acquiring companies. Also, even though management may 'go round' takeover regulations, by deliberately soliciting 'white knights', they have an underlying duty to their companies, particularly to promote shareholder value. This makes directors duties crucial to ascertain the extent to which they may be responsible to shareholders during takeovers. Also, since takeovers directly affect the shareholders of a company, the extent to which they can hold directors to account for unproductive acquisitions through derivative actions is unclear. These two issues form the focus for the next section.

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44 ibid 74-75.

45 Michael Firth, 'Takeovers, Shareholder Returns and the Theory of the Firm (1980) 94 QJA 235 at 255-58. See also, Yakov Amihud, Baruch Lev, and Nickolaos G Travlos, 'Corporate Control and the Choice of Investment Financing: The Case of Corporate Acquisitions' (1990) 45 TJF 603 at 611-15.

IV. Directors duties and Derivative Action under the Companies Act

A. Directors Duties

Following the codification of the duties of company directors, their responsibilities and scope of functions have been clearly defined. Although the duties as outlined under the Companies Act 2006[46] do not make reference to specific corporate matters, they nevertheless serve as a collective touchstone for determining whether company directors have used their powers for the purpose for which they exist. In view of the fact that company directors play active roles in making a takeover bid or in accepting or rejecting one, the duties of directors apply in relation to takeovers.[47] Whilst all the duties apply, the most relevant duties during a takeover are the duties to promote the success of the company, to exercise reasonable care, skill and diligence and the duty to avoid conflict of interests.

Firstly, directors are required to promote the interests of the company 'for the benefit of its members'.[48] Directors are meant to focus on enhancing the interests of the shareholders of their company through the company itself,[49] since the interests of a company as an artificial person, cannot be distinguished from the interests of the persons who are interested in it.[50] Although directors are expected to consider the interests of certain stakeholders, these stakeholders are to be considered only to the extent that the consideration of these interests enhances the interests of the members of the company.[51] This means that

46 Companies Act ss 171 -177.

47 The duties are stated to be the general duties of directors; hence they apply to all investment decisions including takeovers.

48 See Companies Act s 172 (1).

49 Paul L Davies (ed), *Gower and Davies Principles of Modern Company Law* (8th edn, Sweet & Maxwell, 2008) at 508.

50 *Brady v Brady* [1988] BCLC 20 at 40 Nourse LJ.

51 Companies Act s 172 (1).

the duties of directors towards the company are to be measured by reference to the extent to which the interests of members of the company are enhanced. This duty applies in relation to the interests of the shareholders of the target and acquiring companies during takeovers.

When a company becomes a target of a takeover, the directors of the company may accept the bid if it will enhance the value of their shareholders, or oppose the takeover bid if it appears to them that the takeover will not enhance the value of the shareholders of their company. With regards to acquiring companies, the directors should not make acquisitions unless such acquisitions are highly likely to enhance shareholder value of their company. However, it may be difficult to hold directors to account for investment decisions by reference to this duty, because the duty is subjective. Directors are required to act 'in the way that they consider' to be in good faith to promote the success of the company, this has been held to effectively leave business decisions to be made by directors.[52] Although, directors are required to act in good faith in performing this obligation, when they do not act in good faith, as 'an honest' business person would reasonably be expected to act, it is unlikely that they can be held liable for failure to act in good faith. Hence it was observed that the proof that the decisions of the directors of a company had caused substantial harm to the company was evidence against the contentions of the directors that they had acted in good faith rather than an absolute proof that the directors have not acted in good faith.[53] But the decisions of directors can be rejected when such decisions clearly show that they had failed to consider the interests of the company for the benefit of its members.[54] Also, the decisions of the director may be questioned by

52 *Re Smith & Fawcett Ltd* [1942] Ch 304 at 306, Lord Green MR See also, *Cobden Investments Ltd v RWM Langport Ltd* [2008] EWHC 2810 Ch.

53 *Regentcrest Plc (in liquidation) v Cohen* [2001] 2 BCLC 80 (Jonathan Parker J.)

54 *Extrasure Travel insurances Ltd v Scattergood* [2003] 1 BCLC 598.

considering whether an intelligent and honest man in a position of the director of the company could have reasonably believed that the transaction was for the benefit of the company.[55] While directors can actually be made to account for their investment decisions, it is difficult to prove that directors have actually breached their duty to act in the interest of the company, except in cases where they have left a clear record of their thought processes leading up to the challenged decisions.[56]

In light of this, it has been rightly contended that the duty of directors to promote the success of the company as contained in the Companies Act provides little or no guidance either to the directors of a company in making investment decisions or to the courts in reviewing the decisions.[57] Hence, it may be difficult for the shareholders of a company to rely on this duty to hold their directors to account for takeovers that did not promote the interests of their company.

Similarly, the duty to avoid a conflict of interests applies directly to target companies during takeovers. When a takeover bid is made, the decision of directors of target companies to accept or reject the bid should be based only on the extent to which their decisions will enhance the value of the shareholders of their company. They are not to unduly interfere with the bid and they are to ensure that their personal interest does not influence the outcome of the takeover bid.[58] The duty to avoid a conflict of interests is meant to ensure that persons who discharge fiduciary duties should not enter into business negotiations on behalf of a

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55 *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62.

56 Davies (ed) (n 49) 510.

57 Andrew Keay 'The Duty to Promote the Success of a Company: Is it fit for Purpose?' in Joan Loughery (eds), *Directors Duties and Shareholder Litigation in the Wake of the Financial Crisis*, (Edward Elgar Publishing, 2013) at 85.

58 By reference to this duty, directors are required not to oppose a takeover bid to protect their positions in the company. See Tilton L Willcox, 'The Use and Abuse of Executive Powers in Warding off Corporate Raiders' (1988) 7 JBE 47.

company if they have or can have personal interests in the outcome of such negotiations.[59] Yet, as directors who act as company management cannot be excluded from their managerial roles during takeovers, their roles can only be restricted. This is what the current takeover regulations seek to achieve by providing that shareholders should be allowed to decide on the merit of a bid without the interference of management except in relation to their advisory role.[60] Since the purpose of the duty is to exclude directors from acting on behalf of their company when there is a possibility of conflict of interests, it is not exactly clear whether the shareholders of a company can hold directors to account for managerial decision during takeovers by relying on this duty. This is because the managerial role of directors during takeovers has only been restricted, and when the directors use their advisory role to gain personal benefits during takeovers, it may be difficult to prove that they promoted their personal interests over the interests of the company even when this is clearly the case. This duty may have had a clear sense of application if directors' managerial responsibilities were excluded when their companies were subject to a takeover attempt but, unfortunately, this is not the case. The exclusion of the roles of directors during takeovers may be thought to stifle entrepreneurial activities of companies, but as was rightly contended, this argument ignores the fact that the duty merely prevents a director in a situation of conflict of interest from exploiting that situation.[61]

Also, the duty of directors to exercise reasonable care, skill and diligence applies to takeovers. Particularly, this duty applies to the directors of acquiring companies. One of the functions of takeovers is to enhance the corporate

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59 See *Aberdeen Railway Co v Blaikie Bros* [1854] 1 Macq 461 at 471. During takeovers, directors are interested in the outcome of a takeovers bid, because, they may be dismissed post-takeover.

60 The Takeover Directive, Art 9 (5).

61 See similar argument in: Brenda Hannigan, *Company Law* (3rd edn, OUP, 2012) at 241.

and economic value of a company. This means that takeovers should be aimed at enlarging not only the corporate size of an acquiring company, but also its economic value.

Meanwhile, it is difficult to establish the motives of the management of an acquiring company when making acquisitions, but the fact that acquisitions put managements in a better position than they were in before the acquisitions – even when such acquisitions may not lead to significant gains –[62] raises the presumption that they may have cared less whether or not the economic values of a company is enhanced by an acquisition. Usually, the expansion of the company leads to an increase in the responsibilities of the company management; this effectively leads to an increase in their allowances and benefits. Although, when acquisitions lead to losses or zero gains for an acquiring company, it may not be categorically contended that management deliberately ignored the high possibility of losses from such acquisitions but it can be argued that such losses may have been caused by lack of care and diligence. This is because such overpayments may have been averted had the management exercised restraint in deploying their skill and managerial expertise when pursuing acquisitions. In light of this, it is important that shareholders of acquiring companies are protected from managerial hubris[63] during takeovers. Since the current takeover regulations do not contain provisions that are meant to protect the shareholders of the acquiring companies, it appears that regard may be had to shareholder remedies through derivative actions.

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62 Elazar Berkovitch, M P Narayanan, 'Motives for Takeovers: An Empirical Investigation' (1993) 28 Journal of Finance and Quantitative Analysis, 347 at 352

63 See generally: Cathy M Niden, 'An Empirical Examination of White Knight Corporate Takeovers: Synergy and Overbidding' (1993) 2 Financial Management 28. M Raj & M Forsyth, 'Hubris Amongst UK Bidders and Loses to Shareholders' (2003) 8 International Journal of Business 2.

B. Derivative Actions

A derivative action[64] offers company shareholders the opportunity to commence legal proceedings against directors when they breach their duties that are owed to the company. Although directors' duties as provided in the Companies Act are to be owed to their companies, the capacity of the company shareholders to commence proceedings against directors in breach of their duties shows that the shareholders are the beneficiaries of the duties that directors owe to the company. However, in spite of the derivative action procedure, shareholders of an acquiring company face a difficult task in persuading the courts to rule in their favour. This is because the losses that are suffered by shareholders of an acquiring company after a takeover has been concluded arise as a result of the negligent conduct of the directors in the fulfilment of their duty towards the company. As such, it has been held in *Prudential Assurance Co. Ltd v Newman Industries Ltd* (No. 2)[65] that when a company suffers loss as a result of breach of duty by the directors, the loss to shareholders through a reduction in the value of their shares, or loss of dividend, merely reflected the loss suffered by the company, and shareholders cannot recover damages.[66] Respectfully, the decisions of the court with regards to reflective loss suffered by shareholders are unclear, especially when applied to takeovers. During takeovers, gains or losses made by companies are actually measured with reference to the value of shares that are held by the shareholders. It may be thought that when making acquisitions, the directors seek to enhance the economic value of the shareholders of their companies through corporate expansion leading to synergies, so that gains or losses suffered by the company are to be measured by reference to the extent that share prices increase or

64 As provided under the Companies Act, ss 260-269.
65 [1982] 1 Ch 204.
66 See also, *Stein v Blake (No 2)* [1998] 1 BCLC 573.

diminishes post-takeover. In light of this, an attempt was made to distinguish the loss that is suffered directly by a shareholder from the loss that is suffered by the company. It was stated that the rule that a shareholder cannot bring an action when they suffer loss as a result of losses that had also been suffered by the company has nothing to do with a shareholders' right of action for a direct loss caused to his own pocket as distinct from a loss caused to the value of a company in which he holds shares.[67] In furtherance of this, the principle set down in *Prudential Assurance* was reviewed in *Johnson v Gore Wood & Co* thus:[68]

> Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by a breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it, but neither may recover loss caused to the other by breech of the duty owed to that other.

While this may effectively seek to grant the shareholders of an acquiring company the right to commence actions against directors, they must first show that the action is brought in their own right. As indicated in *Johnson v Gore Wood,* the shareholders must show that the loss that they have suffered arises from a breach of the directors' duties, which is owed to them. This decision deviates from the earlier decision in *Prudential Assurance* and it represents an improvement in the protection of the interests of company shareholders especially from the negligent conduct of directors in making acquisitions. But since directors owe the general duties to the company and not to the shareholders particularly,[69] it may be difficult to establish that certain

67 *Heron International Ltd v Lord Grade* [1983] BCLC 244 at 262 (Lawton LJ).
68 [2002] 2 AC 1 Lord Bingham.
69 Companies Act s 170 (1).

duties of directors are owed to the shareholders of a company during takeovers. However, it is arguable whether directors can be said to be acting on behalf of shareholders during takeovers in view of the fact that gains or losses are measured by reference to share prices post-takeovers. Likely, this may be determined by reference to the conduct of the directors and the circumstances of each particular case.

Clearly, the emergence of takeover regulations became necessary since takeovers during the early periods were characterised by the conflict of interests between company management and their shareholders despite the common law duty of care, which was owed to the company by directors. But it has been revealed here that the management of a target company may still undermine the current takeover regulations to promote their personal interests, and the shareholders of the acquiring companies remain unprotected in the absence of any specific regulation to restrain the management of an acquiring company from making negligent acquisitions.

V. Conclusion

Shareholder protection during takeovers has been an issue of much debate. Although, the duties of directors appear to be applicable during takeovers, the ability of directors to undermine these duties when they make specific investment decisions resulted in the establishment of a specific regulatory framework for takeovers. Despite the fact that the objective to protect shareholders from managerial excesses during takeovers influenced the emergence of takeover regulation, the extent to which shareholders are protected during takeovers appears less satisfactory. While current takeover regulation largely focuses on shareholder protection, it emerged that corporate managements still have the capacity to promote their personal interests during takeovers. This was showed to be particularly possible through pre-bid defence strategies that may be used by managements in pursuit of their objectives. Also, it was revealed that the scope of protection that the regulatory

framework of takeovers offers to shareholders is actually limited to the shareholders of target companies. Shareholders of acquiring companies are also affected by the outcome of takeovers. This was examined by reference to the hubris hypothesis of takeovers which occurs as a result of overpayments which is made by management of the acquiring company to the target company in pursuit of a takeover. This in itself represents a transfer of wealth from the shareholders of the acquiring companies to shareholders of the target companies. Irrespective of whether the overpayment made by the management of acquiring companies was motivated by empire building or synergistic gains, management would be expected to be more careful if they have an incentive to engage in careful and scrupulous acquisitions. If they have such an incentive, they would exercise restraints in making acquisitions and reduce the possibility of a loss. Although they may be merely performing their obligations as company management they would also be less likely to make hasty acquisitions where there is a mechanism to regulate their conduct and hold them accountable for careless and avoidable losses which occurs as a result of acquisitions. With respect to this, derivative actions by the shareholders of acquiring companies were revealed to be possible only to the extent that they can show that the directors of their company made acquisitions to enhance the value of their shares specifically and the size of the company generally.

Whether management of acquiring companies should be regulated by direct legal means or supervised by legal institutions depends on the extent to which the interests of the shareholders can be protected while managements can still perform their functions effectively. With respect to target companies, shareholder protection during takeovers can only be reasonably guaranteed by strengthening the current regulatory framework that was created for this purpose.

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