IMPLICIT CONTRACTS, TAKEOVERS, AND CORPORATE GOVERNANCE: IN THE SHADOW OF THE CITY CODE

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by

Simon Deakin
University of Cambridge
ESRC Centre for Business Research
s.deakin@cbr.cam.ac.uk

Richard Hobbs
University of Cambridge
Faculty of Law
rjh57@cam.ac.uk

David Nash
University of Cambridge
Judge Institute of Management
d.nash@jims.cam.ac.uk

Giles Slinger
A.T. Kearney & Co., London
Giles.Slinger@atkearney.com

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Abstract
This paper offers a qualitative, case-study based analysis of hostile takeover bids mounted in the UK in the mid-1990s under the regime of the City Code on Takeovers and Mergers. It is shown that during bids, directors of bid targets focus on the concerns of target shareholders to the exclusion of other stakeholder groups. A review of the case studies five year on finds that that, almost without exception, mergers led to large-scale job losses and asset disposals. However, almost none of the bids was considered by financial commentators, at this point, to have generated shareholder value for investors in the merged company. While there is therefore clear evidence that the Takeover Code is effective in protecting the interests of target shareholders, the implications of the Code for efficiency in corporate performance are much less certain.

Key words: Hostile takeovers, stakeholding, implicit contracts, breach of trust

JEL codes: D23, G34, K22, K31

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1. Introduction

Corporations create economic value through the mutual specialization of human, physical and intangible assets. The mechanisms of corporate governance are the means by which this economic surplus is realized. The issue is how long-term economic relations involving complex commodities, repeat trades, and an uncertain contractual environment are governed, under circumstances where the invisible hand of the market functions less than perfectly to bring about efficient outcomes (Zingales, 1998; Deakin and Hughes, 1999). The presence of multiple stakeholder groups whose inputs are required for production gives rise to overlapping and competing claims to share in the income stream which the firm generates. In the (inevitable) presence of transaction costs there are limits to how far incentives can be perfectly aligned in advance through express contracting. As a result there is scope for the mutual adjustment of claims at every stage of the economic relation. The mechanisms of governance will be more or less successful depending on how well they resolve these distributional conflicts and thereby establish a basis for inter-stakeholder cooperation.

In the modern Anglo-American corporation, the predominant solution to this problem is to assign residual rights of ownership and control to the shareholders. Of all the different corporate constituencies, shareholders, it is argued, have most at stake in the economic success or failure of the enterprise, and so they are most likely to act in a way which enhances the value of the productive venture as a whole, thereby benefiting all concerned (Fama and Jensen, 1983). In addition, internal governance costs within the group of shareholders are low, precisely because they share the common goal of maximizing their financial return; there is less scope for costly divergencies of interest of the kind which arise between different employee or supplier groups. The prevalence of the shareholder model in the USA and Britain is therefore said to represent the 'survival' of an efficient form of governance, at the expense of less efficient alternatives (Hansmann, 1996). In this vein it is further argued that, as a result of globalisation, corporate governance systems are converging on the Anglo-American 'shareholder primacy' norm (Hansmann and Kraakman, 2001).

A contrary view is that the dominance of the shareholder primacy norm has potentially negative distributional implications for other stakeholder groups which in turn put in question its wider effects on corporate performance and national competitiveness. If prioritising returns to shareholders means that other stakeholders are less willing to risk firm-specific investments in human and physical capital than they would otherwise be, the negative effects on corporate performance will be felt more widely. In the long run, shareholders would lose out too (Blair, 1995; Deakin and Slinger, 1997; Blair and Stout, 2000). This can be read as implying that the shareholder primacy norm enjoys its elevated status in the Anglo-American systems to factors other than efficiency, such as institutional lock-in and other consequences of path dependence. It also suggests that systems which do not observe the shareholder primacy norm are not necessarily, for that reason, suffering a competitive disadvantage.

These issues are crystallized in the situation of the hostile takeover bid. Supporters of an active market for corporate control claim that it serves to shift assets to more efficient uses while also enhancing the accountability of managers to shareholders. However, it has been suggested that the source of gains in takeovers derives not from the more efficient use of corporate assets post-merger, but from the ability of managers to breach with impunity the 'implicit contracts' of non-shareholder constituencies. Because the expectations of employees and other constituencies with asset-specific investments are not adequately protected by law, they are vulnerable to a 'breach of trust' which serves to transfer wealth to shareholders at the expense of long-term performance of the enterprise (Shleifer and Summers, 1988).

This paper offers a qualitative, empirical perspective on the operation of implicit contracts within takeover bids. The evidence is drawn from case studies of hostile takeover bids mounted in the UK in the mid-1990s under the regime of the City Code on Takeovers and Mergers. On the basis of interviews carried out following takeover bids, we report the perceptions of the bid process of market professionals and others involved, including company directors and employee representatives. We thereby provide evidence of the relative weight placed on particular regulatory factors by those involved in the takeover process, and of the perceived degree of influence of the different stakeholder groups. We then look at the outcomes of the bids five years on. We find that, almost without exception, successfully-completed takeovers led to large-scale job losses and asset disposals. However, almost none of the bids was considered by financial analysts, at this point, to have generated shareholder value for investors in the merged company.

The argument is developed as follows. Section 2 below outlines the theoretical positions which have been taken within the law and economics literature on the role of implicit contracts and related mechanisms of corporate governance in the takeover context. Section 3 then outlines the contents of the City Code and evaluates its provisions from the point of view of the rival theoretical positions on implicit contracts and takeovers. The Code's provisions on equal treatment of shareholders, takeover defences, and the position of non-shareholder constituencies are for this purpose compared to those adopted in equivalent measures in the US and Germany, and reference is also made to the contents of the draft EC Directive on takeover bids (the 'Thirteenth Directive'). Section 4 then reports the empirical findings of the empirical study of the operation of the Code and section 5 traces the subsequent history of mergers arising from the bids. In the concluding section we consider the significance of the findings for the theory of implicit contracts within corporate governance.

2. Implicit contracts in hostile takeovers: the 'breach of trust' hypothesis

For its supporters, the hostile takeover mechanism serves to align the interests of managers and shareholders, thereby minimizing agency costs associated with the separation of ownership and control in large, publicly-held corporations. The appropriate response of management to a hostile bid is to adopt a position of 'passivity' or 'neutrality', ruling out takeover defences and leaving the shareholders free to decide the fate of the company in the event of a bid (Easterbrook and Fischel, 1991). In so far as the target board is required to take any positive steps in response to the bid, its duties are confined to instigating an 'auction' based on competing offers, thereby ensuring that shareholder returns are maximized. Some combination of these two positions – the 'passivity' and 'auction' views of the role of target management – represents the broad consensus within corporate finance and corporate governance scholarship and also among policy circles in Britain and America.

A bidder is normally required to offer a market premium to the existing shareholders, in the form of an offer price well in excess of the current market value of the shares, if it is to be successful. The technical form in which this is done is called in the USA a 'tender offer' – this means an offer made directly to the shareholders, over the head of the board (by contrast, a 'proxy fight' involves the use of votes in a general meeting to replace the existing board with a new one). The equivalent of a tender offer is also the normal way of proceeding with a bid in the UK, under the rules of the City Code on Takeovers and Mergers. The premium paid by the bidder as part of a tender offer may be justified by its confidence that it can the company can be run more efficiently after the merger has been completed.

The logic of the bid is that at the time of the bid, the target's share price has fallen below its potential value, thanks to mismanagement by the incumbent team. This, at least, is the theory which lies behind the 'passivity' and 'auction' views. Empirical evidence, however, has proved resistant to the theory's predictions.

Since the late 1970s, the economic effects of takeovers have been the focus of intensive study. Econometric analyses have shown that it is not necessarily the worst performing companies which are targeted for takeover; in particular in the UK (and to a lesser extent in the United States) size is a more relevant factor (see Franks and Mayer, 2000). Nor do mergers following hostile bids consistently lead to improved performance. While hostile bids do better than agreed mergers, on average there is only a small positive effect on share prices from hostile takeovers (Cosh and Guest, 2001), and the range of outcomes is wide (Mueller and Sirower, 1997). Thus, while target shareholders undoubtedly do well from hostile takeover bids, shareholders in bidder companies, on average, make only slight gains, if that. Such evidence puts in doubt the theoretical claim that hostile takeovers enhance the efficiency and competitiveness of organizations.

An alternative explanation for the high takeover premiums paid to target shareholders was provided by the 'breach of trust' hypothesis developed by André Shleifer and Lawrence Summers in a much discussed paper published in 1988. The paper was developed against the backdrop of the activities of corporate 'raiders' such as T. Boone Pickens and Carl Icahn who were active in US takeover markets in the mid-1980s. Several hostile bids mounted at this time led to large-scale job losses in organisations where employment security had previously been a stated priority of management.

The key to the 'breach of trust' hypothesis was the analysis of implicit contracts. According to the theory, employees are willing to make firm-specific investments in human capital in return for an implicit promise of job security which amounts to a return on their 'investment'. Firm-specific human capital in this context means 'skills or knowledge or networks of personal relationships that are specialized to a given enterprise and that are more valuable in that enterprise than they would be in alternative uses' (Blair, 1996: 8). Because of such specialization, employees become 'locked in' to a particular enterprise. They thereby become vulnerable to ex post renegotiation of implicit contract terms by management. In the context of a hostile takeover, downsizing enables management to capture the future 'rents' or income streams which would otherwise have accrued to employees, and to convert them into takeover premiums for the shareholders' benefit. Because this practice directly benefits shareholders only at the employees' expense, it is a simple wealth transfer. Its impact on productive efficiency is at best neutral, but more likely negative. As Margaret Blair (1996: 12) puts it,

> Firms that focus solely on share value will have an incentive to shut down operations that are not generating profits for shareholders even though these operations may still be generating substantial real economic rents. From the point of view of society at large, this is, obviously, inefficient. Moreover, over time such policies are likely to discourage further investments by employees in firm-specific human capital.

The Shleifer and Summers paper identified the hostile takeover as the principal mechanism by which the redistribution of wealth from employees to shareholders takes places. As long as the incumbent management remains in place, implicit contracts with employees are enforced through reputational effects. Companies which renege on expectations of continuing employment will be unable to motivate existing employees or attract new ones. However, following a successful bid, a new management team comes in and finds itself in a different position. The new team aims to realize short-term gains to meet the costs of the takeover through asset disposals which, in themselves, reduce the need to attract and retain employees. In effect, the post-bid restructuring places the parties in an endgame situation, where implicit contracts ceased to be self-enforcing. The effect was summed up as follows (Shleifer and Summers, 1988: 44):

> Hostile takeovers are external means of removing managers who uphold stakeholder claims. Takeovers then allow shareholders to appropriate stakeholders' ex post rents in the implicit contracts. The gains are split between the shareholders of the acquired and the acquiring firms. At least in part, therefore, the gains are wealth redistributing and not wealth creating.

Yet a similar argument could equally well have been made in the case of shareholders. The 'nexus of contracts' view of the corporation sees managers as the agents of the shareholders, running the enterprise on their behalf with the aim of achieving a return on their investment. This 'contract' (which in legal terms can be thought of as consisting of the terms of the memorandum and articles of association or, in the US context, the corporation's by-laws), like the employment contract, is potentially open-ended, and similarly subject to unforeseen contingencies. However, in each of the cases considered by Shleifer and Summers, there was a fundamental difference in treatment (not referred to in the paper) between shareholders and employees which arose from the prevailing institutional framework. Shareholder expectations were just as 'implicit' as those of employees, but shareholder's claims were protected by corporate and (in particular) securities law in a way which had no equivalent for employees.

Enforcement of implicit contracts through reputational effects is very far from being the whole story. Understandings which are implicit ex ante may become explicit ex post through the device of a *property rule* which grants residual decision-making power to one party. Thus at the point of deciding the fate of the company in response to an outside bid for control, in Britain and the USA, residual control rights are asserted in such a way as to ensure that shareholders, *and only shareholders*, get to decide. In order to explain the differential treatment of shareholders and employees, it is necessary to examine these institutional origins of shareholder primacy in the Anglo-American systems in more detail.

3. Institutional support for shareholder primacy: directors' duties, takeover codes and employee voice

There is only limited legal support for the shareholder primacy norm within the core of corporate law. In UK company law, directors, when taking commercial decisions, are said to owe a duty to act in good faith in the interests of the *company*. In the USA, Delaware corporate law (the choice of legal regime for most large US companies) has an essentially similar rule, although it is sometimes phrased more explicitly as a duty owed to the *members*, that is, the shareholders. Both UK law and Delaware law allow directors leeway to take into account the interests of non-shareholder constituencies, to the extent that this is done with the aim of enhancing shareholder value. The DTI Company Law Review, which was completed in 2002, referred to this as the idea that directors are entitled to pursue 'enlightened shareholder value'; its proposed restatement of directors' duties 'requires directors to act in the collective best interests of shareholders, but recognises that this can only be achieved by taking due account of wider interests' (Company Law Review Steering Committee, 2000: 14-15). Section 309 of the Companies Act 1985 already requires directors to consider the interests of employees along with those of the shareholders when exercising their fiduciary duties. In the US, a large number of states passed so-called 'stakeholder statutes' in the 1980s which shielded boards from potential liability to shareholders in respect of decisions including responses to takeover bids. Although Delaware was not among these states, its judges have, from time to time, stressed that boards have scope to balance the interests of different stakeholders in the overall interests of the company as a productive entity.[1] Procedural rules and protections for directors against suit also confer considerable discretion on boards. Shareholder litigation is very rare in the UK thanks to procedural bars including the rule in *Foss* v. *Harbottle*.[2] Under Delaware law, a generously wide 'business judgment rule' protects directors from personal litigation in most cases where they can shown to have acted in good faith.

Looking purely at the general principles of corporate law, target boards have considerable leeway to resist hostile takeover bids, almost to the extent of adopting a 'just say no' policy. Indeed, until comparatively recently, boards in both the US and the UK did precisely this. During the 1930s, UK boards routinely dismissed outsiders' attempts to prise away control, often not even informing shareholders that a bid was on the table. Directors of listed companies insisted that negotiations with bidders had to be conducted on a confidential basis (Hannah, 1974; Njoya, 2002: 144-5).

The position began to change as the consequence of the revolution in securities law and accounting practice which began in the US with the passage of federal securities legislation in the 1930s (the Securities Act 1933 and Securities and Exchange Act 1934) and in the UK with the Companies Act 1948. These measures, together with the gradual development of stock exchange rules, required companies to disclose a wider range of information in their published accounts and to inform the regulatory authorities of a increasingly large category of material changes in commercial circumstances. Hostile takeovers were a response to this new regulatory regime which began to gather momentum in the late 1950s and increased in significance in the course of the 1960s. From an early stage, there was concerted pressure from shareholder groups for regulatory intervention to protect their interests. In the UK this led to the issuing in 1959 of the Notes on Amalgamations of British Businesses, a code of conduct drawn up with the encouragement of the Bank of England. This laid down the principle that the decision to sell or retain shares was a matter for the shareholder, who was entitled, in making that decision, to receive all relevant information from the board of the company (Johnston, 1980; Njoya, 2002: 146). In 1968, the Notes gave way to the City Code on Takeovers and Mergers, which was drawn up and administered by a self-regulatory body, the City Panel on Takeovers and Mergers. Also in 1968 the US adopted federal legislation, the William Act, which amended the Securities and Exchange Act of 1934. In common with the trend in the UK, the Williams Act introduced disclosure requirements in connection with takeover bids, with the aim of protecting shareholder interests.

Since the late 1960s the City Code has evolved to encompass a substantial body of principles and rules relating to the conduct of takeover bids. Formally, the Code is 'soft law' which depends for its enforcement on the threat that an individual found to be in breach of its provision may lose the necessary license to practise in the area of investment business in the UK. This is a sufficiently powerful threat to ensure near-complete compliance with rulings of the Panel. The power is currently exercised by the Financial Services Authority (FSA), which has endorsed the City Code as a relevant instrument of self-regulation under the terms of section 143 the Financial Services and Markets Act 2000. The involvement of the FSA, a statutory body, does not diminish the essentially self-regulatory character of the Panel, which consists of representatives from a number of financial organizations and professional associations in the City of London.

The Code is founded on a principle of equal treatment of shareholders: 'all shareholders of the same class of an offeree company must be treated similarly by the offeror'.[3] This means that 'partial bids' which discriminate between classes of shareholders are forbidden. The Code's 'mandatory bid rule' requires the bidder, once it has acquired 30% or more of the voting rights of the company, to grant all shareholders the chance to sell for the highest price it has paid for shares of the relevant kind within the offer period and the 12 months preceding it.[4] Likewise, the Code stipulates that information given out by either the bidder or target directors must be made 'equally available to all shareholders as nearly as possible at the same time and in the same manner'.[5] The Code also imposes on target directors a series of specific obligations. They must obtain competent, independent financial advice on the merits of the offer,[6] which they must then circulate to the shareholders with their own recommendation.[7] Any document issued by the board of either the bidder or the target must be accompanied by a statement that the directors accept responsibility for the information contained in it. The effect of this is to create a legal duty of care, owed by the directors to the *shareholders* to whom the information is issued, and not to the *company* as is the case with their general fiduciary duties.[8] In effect, then, the directors of the target in the position of being required to give disinterested advice on the merits of the offer.

The Takeover Code is not silent on the interests of other stakeholders. General Principle 9 states that 'it is the shareholders' interests, taken as a whole, together with those of employees and creditors, which should be considered when the directors are giving advice to shareholders'.[9] In addition rule 24.1 requires the bidder to signify, in its offer document, 'its intentions regarding the continuation of the business of the offeree company; its intentions regarding any major changes to be introduced in the business, including any redeployment of the fixed assets of the offeree company; the long-term commercial justification for the proposed offer; and its intentions with regard to the continued employment of the employees of the offeree company and its subsidiaries'.[10] However, these provisions do little to counter-balance the specific duties of disclosure owed to shareholders under the Code. General Principle 9 is no more enforceable by employees than is section 309 of the Companies Act.[11] Employees have no standing to make representations before the City Panel. Moreover, the statement of future intentions which rule 24.1 requires of the bidder is unlikely, in itself, to give rise to any legal commitments. In practice, it is easily satisfied by a boilerplate formula inserted into offer documents, according to which the bidder simply undertakes to observe the employees' pre-existing legal rights, something which is little more than a statement of the obvious in this particular context.

The Code, together with other aspects of securities law, also hampers potential anti-takeover defences in various ways. Once an offer is made or if the target board has reason to believe that it is about to be made, the target board cannot issue new shares; issue or grant options in respect of any unissued shares; create securities carrying rights of conversion into shares; sell, dispose or acquire assets of a material amount, or contract to do so; or 'enter into contracts otherwise than in the ordinary course of business'.[12] The 'proper purposes' doctrine of company law likewise prevents the board issuing shares for the purpose of forestalling a hostile takeover, even well in advance of any bid being made.[13] The issuing of non-voting stock, which a board might do in an attempt to entrench its control, is permissible as a matter of company law, but has been vigorously opposed by organized shareholder interests, as expressed through the Institutional Shareholders' Committee's code of practice.[14] Under both company legislation and the rules of the UK Listing Authority, companies must take actives steps to contract out of protection for pre-emption rights, that is the rights of existing shareholders to be granted preference when new stock is issued.[15]

The overall effect of the Code is that the open-ended duty of directors to act in good faith in the interests of the company is, for the duration of the takeover bid, transmuted into a specific duty to have regard to the immediate financial interests of the shareholders. The board is required to be neutral during the bid, and may only with difficulty erect takeover defences in advance; hence management 'passivity' is, by and large, the order of the day. Its obligation to provide an objective assessment of any bid implies a limited duty to hold the ring during an auction but it is not required to take active steps to solicit additional bids.

US law on takeovers is broadly similar to that in the UK, although it is tilted more clearly in the direction of an auction rule rather than a rule of neutrality or passivity, and there are significant institutional differences which have implications for the way in which takeover bids are conducted. The Williams Act is less extensive as a regulatory instrument than the Takeover Code. It does not impose a bid timetable as the Code does, and its impact on takeover defences is less far-reaching. The main effect of the Act is to require information disclosure and to impose (from 1995 onwards) a version of the equal treatment principle, under which the tender offers must be made available to all shareholders of the relevant class.

The closest equivalents to the Code's provisions on defences and treatment of stakeholders are to be found in the Delaware case law, the result of the more prominent role played by shareholder litigation in the US system. Contrary to the position in the UK, the Delaware courts allow target boards to put in place 'poison pills' or shareholder rights plans which require bidders to buy out existing interests at an enhanced premium or, with the same result, have the effect of diluting the bidder's own stock following the acquisition. Under *Unocal*[16] the Delaware Supreme Court effectively operates a proportionality test, by virtue of which a defensive measure will be protected by the business judgment rule if it is 'reasonable to the threat posed'. The directors are entitled to conduct an analysis of the impact of the bid on the corporate enterprise, taking into account factors which include 'inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, employees, and perhaps even the community generally), the risk of nonconsumption, and the quality of securities being offered in the exchange'. Notwithstanding this dictum, in *Revlon*[17] the Court ruled that a particular kind of takeover defence – a 'lock up' of assets, such as giving a friendly third party of ‘white knight’ the right to buy them at a discount should its own offer fail – was subject to a special test. This kind of device would be acceptable only if the effect was to elicit an auction between competing bidders, rather than deterring potential bids. The court came close to articulating a an exclusive shareholder interest test by ruling that, once the sale of control to one bidder or another becomes ineveitable, the board’s only duty is to ensure that shareholder receive the highest value possible for their stakes. Later decisions[18] have demonstrated the Delaware courts’ continuing ability to ‘zig zag’ between pro- and anti-defensive rulings (Roe, 1993), a quality which helps to ensure that neither of the two core constituencies to which Delaware has to appeal – managers and institutional shareholders – is sufficiently alienated to consider pressing for reincorporation in a more ‘friendly’ jurisdiction.[19]

In the US context, then, it would seem that regulatory competition between the states, some of which are willing to adjust their corporate laws to attract reincorporations, has resulted in a particular configuration of takeover law, under which takeover defences in the form of poison pills are permissible. There are two schools of thought on the effects of this evolution. One maintains that as a result of the leeway allowed to poison pills, Delaware law is unduly pro-management, the consequence of the need to appeal to incumbent managers who have the all-important say in where the company is to be incorporated (Bebchuk and Ferrell, 2002). The other, by contrast, evaluates the process of regulatory arbitrage in a more positive light, by suggesting that the Delaware rule permits poison pills, by and large, only to the extent compatible with the goal of maximizing shareholder choice in the event of a takeover; poison pills are in general legitimate only to the extent that they are redeemable, so that rather than posing an insurmountable barrier to an external bid, they merely increase the price which a bidder is required to pay (Kahan and Rock, 2002).

While it is difficult to resolve this debate in the absence of more compelling evidence of the efficiency effects of poison pills, the comparison with the UK position is instructive from a public choice point of view. The UK lacks a similar mechanism of regulatory competition to that which operates in the USA. The City Code, in articulating a strongly pro-shareholder position the issue of on management passivity, reflects the influence which institutional shareholders and City professionals have been able to bring to bear on the regulatory process. It is largely thanks to concerted shareholder pressure that poison pills and the more obvious kinds of takeover defence, such as ‘shark repellents’ and ‘flip overs’, have not been adopted to any anything approaching the levels seen in the USA.

It is also clear that neither system has generated processes which would have the effect of protecting stakeholders against the threat of expropriation postulated by the ‘breach of trust’ hypothesis. The *Revlon* decision suggests that stakeholder considerations will tend to take second place once it is clear that the company will be auctioned off to the highest bidder. In the UK, the same effect arises from the absence of any standing for employee representatives in the City Panel’s processes of adjudication and rule-making. Nor does employment law provide a substitute remedy in either system. In the context of US federal labour law, restructurings and reorganisations of the enterprise which result from commercial transactions such as takeovers are not covered by the employer’s duty to bargain under the National Labor Relations Act[20] (and in any event mandatory collective bargaining covers less than 10% of the US private sector workforce). The equivalent UK provisions are those parts of employment law which impose a duty on the employer to inform and consult employee representatives in situations of redundancy and business transfers.[21] Although the sale of a business or part of a business triggers a duty to consult, there is no such duty merely in the event of a hostile bid being mounted; neither the target nor the company is obliged to consult at this point. The rules of the UK Listing Authority, which mandate prompt disclosure of material information to shareholders, also make it difficult for companies to consult employee representatives over the substance of large-scale restructurings at en early stage in the decision-making process.

The approach taken by the German Takeover Law, in force from 1 January 2002, highlights, by comparison, the marginalisation of employee voice in the Anglo-American systems. Section 33 of the new law permits the target management to put in place anti-takeover defences if they are either supported by a 75% vote of the shareholders, or authorized in advance by the supervisory board. This last reference is highly significant as, in the case of companies subject to the codermination laws, employees have equal representation with shareholders on the supervisory board, and in some cases the casting vote will be exercised by a non-shareholder chair. Section 33 had initially required shareholder approval for defensive measures in all cases, but was redrafted at a very late stage in the legislative process to incorporate the alternative of authorization through the supervisory board. Richard Painter and Christian Kirchner comment (2002: 15) that ‘[t]his change in section 33 was clearly motivated by protectionist forces, forged together by certain management interests and the lobbying of labor unions fearful of the impact of hostile takeovers on German codetermination'. Whether or not the measure is any more 'protectionist' in favour of labour than the City Code is in favour of shareholders, it would seem that the feature of German corporate governance which most clearly distinguishes it from its British and American counterparts, namely the incorporation of employee voice directly into corporate decision making and lines of accountability, has here come to be reflected (at least thus far) in the takeover regulation regime (see also Höpner and Jackson, 2002).

A further contrast is provided by the proposed EU Thirteenth Company Law Directive. This measures aims to put in place a harmonizing set of rules for shareholder protection which are essentially inspired by the City Code. The Directive would outlaw bid-frustrating tactics by target boards, require the target board to obtain neutral financial advice on the merits of a bid, and impose various duties on bidders, including an obligation of equal treatment with regard to shareholders of the target, thereby ruling out 'coercive' bids. When a revised draft of the Directive was considered by the European Parliament in late 2000, the Parliament insisted that the implications of takeovers for employment should play a part in the assessment of bids. It also rejected the European Commission's view that the correct attitude for the target board to take during a bid was one of 'neutrality'. The Commission responded by insisting that employee consultation was not an appropriate objective for the Directive, and (somewhat disingenuously[22]) claimed that adequate protection was already provided by the Acquired Rights Directive.[23] A Conciliation Committee was set up to mediate between the Commission and the Parliament on this and other matters. This led to agreement on a new set of amendments which (among other things) would have required the board of the target company to set out its 'views on the effects of the [bid] on all the interests of the company, including employment, and on the offeror's strategic planning for the offeree company and its likely impact on jobs and locations'; the board of the bidder would have been required to issue a similar statement, relating to its intentions. This fell short of a requirement on either company to enter into consultations with employee representatives. When the Directive was finally put to the vote in July 2001, the result was a tie (273 votes on each side), which meant that the proposal fell.[24]

Notwithstanding this failure, the Internal Market Directorate of the European Commission has made clear its intention to resurrect the draft Directive. In January 2002 it published the report of a high level group of company law experts

(European Commission, 2002). This report sidestepped the issue of employee consultation on the grounds that while ‘the interests of other stakeholders and in particular of employees may be at stake in the context of a takeover bid, [the group] believes that this in itself does not justify measures by the board which deny shareholders the opportunity to successfully tender their shares to a bidder who is willing to buy their shares’ (European Commission, 2002: 16). In this context, it would seem to be significant the Thirteenth Directive is an internal market measure, over which the Directorate General for Employment and Social Affairs, which is responsible for employee consultation measures, has no say. Since the report of the high level group, a judgment of the European Court of Justice, ruling that the retention by governments of ‘golden shares’ in privatized corporations could contravene EC rules on state aids to industry, has put further pressure on the Parliament to reach agreement on the text of the Thirteenth Directive.

In short, the City Code embodies in a particularly clear way the principle that, during the course of a takeover bid, directors of the target company are meant to act as the agents of the shareholders. Appeals to ‘enlightened shareholder value’ are of little relevance in this context; the shareholders are entitled to the protection of their short-term financial interests. It would appear, then, the claims of non-shareholder constituencies to the protection of their implicit contractual interests in the corporate enterprise as a continuing productive entity count for little. The position appears to be starkly pro-shareholder not simply by reference to recent German practice, but also by comparison to the US position, which allows certain poison pill defences (although, it would seem, only to the extent that they lead to a higher immediate return to the shareholders). We now turn to an examination of how the City Code works in practice.

4. Empirical evidence: a qualitative study of takeover process

4.1 The study: aims, methods, scope

Although there are literally hundreds of econometric analyses of aspects of hostile takeover bids, the breach of trust hypothesis has been relatively little studied using this methodology. The quantitative methods which are used to measure the effects of bids upon shareholder wealth are not able to specify whether those gains came from increased productive efficiency or wealth transfers. One study, which found evidence that hostile takeovers in the UK between 1987 and 1996 were associated with significant falls in both employment and output, concluded that, after controlling for the change in output, the overall effect of such mergers was to enhance the efficiency with which labour was utilized at firm level. On this basis the paper claimed that 'the results are generally supportive of the view that merger activity, particularly related and hostile merger activity, promotes efficiency'. However, the authors also accepted that 'if the observed employment reductions constitute a reneging on the implicit terms of the labour contract, in the sense of Shleifer and Summers (1988), there may be associated costs generated through the subsequent reductions in firm-specific human capital investment by employees. These will be manifested in lower output levels but any such changes would be very hard to identify' (Conyon et al., 2002: 40).

To make progress in understanding the effects of hostile takeovers and of takeover law, there is scope for alternative methods including qualitative analyses and case studies. These can provide richer information on the motivations and perceptions of those affected by bids and on the potential range of trajectories of companies following bids than is available from econometric studies which are, by definition, remote from these kinds of data. In this vein, the present paper reports the findings of a qualitative study of hostile takeovers and their aftermath. The first aim was to analyse how the takeover process and takeover regulation, including the City Code, structured the consideration by boards of different stakeholder interests. A non-random sample of 15 takeover bids was identified for close study. The objective was to construct a sample of bids which contained examples of both hostile and agreed bids, and cross-border bids by UK companies and for UK companies mounted during the period 1993-1996. Interviews were conducted with company directors, legal and financial advisers and trade union officials in the relevant companies. During 1993-96 over 40 interviews were conducted with institutional investors, company directors, employee representatives, lawyers, merchant bankers and representatives of various official market bodies (including the Association of British Insurers and the Takeover Panel). The purpose of this stage of the research was to assess how those directly involved in takeover bids perceived their effects, in particular their distributional implications for the different stakeholder groups. In 2001, a further sub-sample of companies was revisited for the purpose of assessing how, several years after the bid, the takeover was now viewed.[25]

By way of background to the study, it useful to note some features of the takeover wave of the mid-1990s, of which our sample of bids formed a part. From a peak in 1989, the UK takeover market became relatively quiet during the early 1990s. This slump ended dramatically with an explosive increase in takeover value – rather than numbers of bids – in 1995 and 1996. A few extremely large hostile takeover bids were seen, most notably Glaxo/Wellcome and Lloyds/TSB. In value terms, the market for corporate control became as important in the mid-1990s as it had been in the late 1980s. Features of the market in the mid-1990s included a huge jump in the value of continental European acquisitions in the UK, and a septupling in the value of UK public deals from £5 billion in 1994 to a then record £36 billion in 1995.

Table 1 charts hostile bids as a proportion of all bids for the period in question and indicates the overall incidence and success rates of bids. Table 2 lists details of the 15 bids which formed the sample. This indicates the pre-bid prices, the first and final offers, the bid timetables (relevant dates), the composition of offers (cash, shares and debt), the takeover premiums paid in successful bids, and the outcomes of bids.

Table 1. *Incidence and success rates of UK Public Takeover Bids, 1993-1996*

UK Public Bids 1993-1996		**Contested Bids**			**Agreed Bids**			**% of Total Bids**		**All Bids**
		Contested	Late Agreement	Total Contested	Agreed	White Knight	Total Agreed	Contested	Agreed	**Totals**
1993:	Completed	2	3	5	51	2	53			58
	Failed	6	0	6	4	0	4			10
Success Rate (%):				*45.5%*			*93.0%*			85%
	Total:	8	3	11	55	2	57	16.2%	83.8%	68
1994:	Completed	6	2	8	55	0	55			63
	Failed	3	0	3	6	0	6			9
Success Rate (%):				*72.7%*			*90.2%*			88%
	Total:	9	2	11	61	0	61	15.3%	84.7%	72
1995:	Completed	6	4	10	75	2	77			87
0	Failed	7*	1	8	5	0	5			13
Success Rate (%):				*55.6%*			*93.9%*			87%
	Total:	13	5	18	80	2	82	18.0%	82%	100
1996:	Completed	8	2	10	77	0	77			87
	Failed	5	0	5	5	1	6			11
Success Rate (%):				*66.7%*			*92.8%*			*88%*
	Total:	13	2	15	82	1	83	15.3%	84.7%	98
1993-96 Totals:										
	Completed	22	11	33	258	4	262			295
	Failed	21	1	22	20	1	21			43
Success Rate:				**60%**			**92.6%**			**87.3%**
	Totals:	**43**	**12**	**55**	**278**	**5**	**283**	**16.2%**	**83.8%**	**338**

Source: *Mergers and Acquisitions Monthly*, 1992-1997.

* Includes 3 bids in a new category: 'recommendation given then withdrawn,' which was not mentioned before the report on 1995.

Note: The category 'initially contested, then agreed,' was not used prior to the report on 1992. These bids have been counted as hostile bids.

Table 2. *Dates, prices, takeover premiums and results in selected takeover bids 1993-1996*

Bidder	Target	Bid type	Pre-bid price	Formal offer	Final offer |(if different)	Premium	Result
Kingfisher	Darty	Agreed	3 Feb 1993 519FF	18 Feb 1993 520FF		0%	18 Feb 1993 Agreed
British Aerospace	VSEL	Agreed	28 Sept 1994 973p	12 Oct 1994 1260p (shares) 1140p (cash)	31 May 1995 1747p (shares) 1600p (cash)	64%	10 June 1995 Withdrawn
GEC	VSEL	Agreed	28 Sept 1994 973p	28 Oct 1994 1400p (cash)	8 June 1995 1081p (cash + shares) 1100p (cash)	121%	19 June 1995 Agreed
Trafalgar House	Northern Electric	Hostile	13 Dec 1994 910p	19 Dec 1994 1077p (cash + shares) 1048p (cash)	23 Feb 1995 1081p (cash + shares) 1100p (cash)	21%	4 Aug 1995 Withdrawn
Glaxo	Wellcome	Hostile	20 Jan 1995 688 p	20 Jan 1995 1025p (cash)		49%	8 Mar 1995 Agreed
Southern	SWEB	Hostile	7 July 1995 801p	13 July 1995 900p (cash)	25 Aug 1995 981 p (cash + debt)	22%	18 Sep 1995 Unconditional
Scottish Power	Manweb	Hostile	21 July 1995 730p	24 July 195 945p (cash + shares) 915p (cash)	18 Sep 1995 1025p (cash + shares) 990p (cash)	36%	6 Oct 1995 >50% acceptances

Hanson	Eastern	Agreed	28 July 1995 700p	31 July 1995 975p (cash)		39%	31 July 1995 Agreed
RPR	Fisons	Hostile	17 Aug 1995 193p	18 Aug 1995 240p (cash)	5 Oct 1995 265p (cash)	37%	11 Oct 1995 Agreed
Harnishfeger Industries	Dobson Park Industries	Hostile	1 Sep 1995 83p	8 Sep 1995 110p (cash)	26 Oct 1995 130p (cash)	57%	26 Oct 1995 Agreed
United Utilities	Norweb	Agreed	6 Sept 1995 917p	8 Sept 1995 975p (cash) 1015p (cash + shares)	11 Oct 1995 1170p (cash + shares + debt) 1150 p (cash + debt)	25%	7 Nov 1995 Unconditional
Texas Energy	Norweb	Agreed	6 Sept 1995 917p	28 Sept 1995 1050p (cash + debt)	3 Oct 1995 1085p (cash + debt)	18%	11 Oct 1995 Withdrawn
Lloyds Bank	TSB	Agreed	6 Oct 1995 274p	11 Oct 1995 335p (shares + debt)		22%	11 Oct 1995 Agreed
Granada	Forte	Hostile	21 Nov 1995 275 p	22 Nov 1995 338.6p (cash + shares) 321.7p (cash)	9 Jan 1996 373p (cash + shares) 362p (cash + debt)	32%	23 Jan 1996 >50% acceptances

4.2 Perceptions of the regulatory process

We asked market participants for a description of a particular bid, and in that particular instance, their opinions about the effects of the regulatory system: company law, the Takeover Code, European law, tax law and the MMC. Interviewees answered whether a particular factor had or had not affected the outcome of a bid. The Takeover Code and related Rules Governing Substantial Acquisitions of Shares were rated as an important factor by 90% of respondents, the highest score of any single factor (see Figure 1). A quarter of all respondents considered that regulatory factors had affected the outcome of the bid. Regulatory factors were thought to be more likely to have this effect in the case of hostile takeovers.

We then asked interviewees whether consideration and priority had been given to shareholders, employees and creditors. All 33 responding interviewees thought that directors had 'considered' shareholders' interests. In the 31 of these cases where 'priority' was addressed, the result was again unanimous that shareholders had been given priority. At the other end of the scale, 'priority' was never given to creditors, and 'consideration' was only thought to have been given to this group in a few cases - merchant bankers discussing agreed bids were the most likely to report that consideration had been given to creditors. While 31% of all respondents reported that employees had been given priority, this result depended on high ratings from trade union representatives (80%) and directors (50%) rather than lawyers (8%), and on a large number reporting priority to employees in agreed bids (55%) rather than hostile bids (13%).

The effects of the bid were then analysed using questions which asked about net benefit or net loss to various groups on each side of the bid. Respondents had to assimilate gains and losses to individual groups and even to individuals – for example to employees or directors who might have lost their jobs, but who experienced capital gains from shareholding value rises and from redundancy pay-offs. While 100% of respondents considered that target shareholders gained from bids, only around 40% considered that target employees did so. Table 3 reports these results and Figure 2 represents the means of the perceived effects on different groups.

Figure One. *The importance of regulatory factors in determining takeover outcomes*

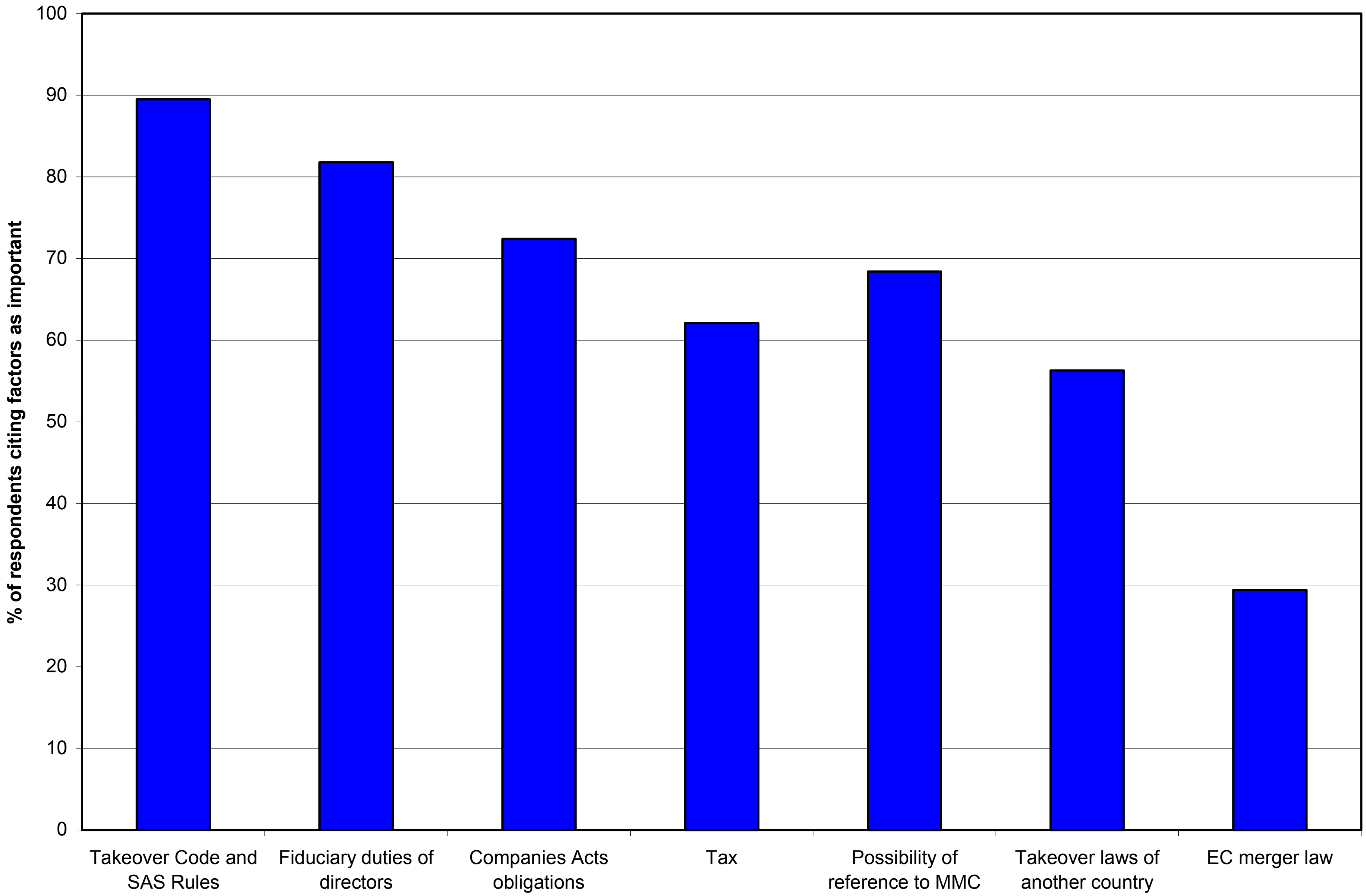
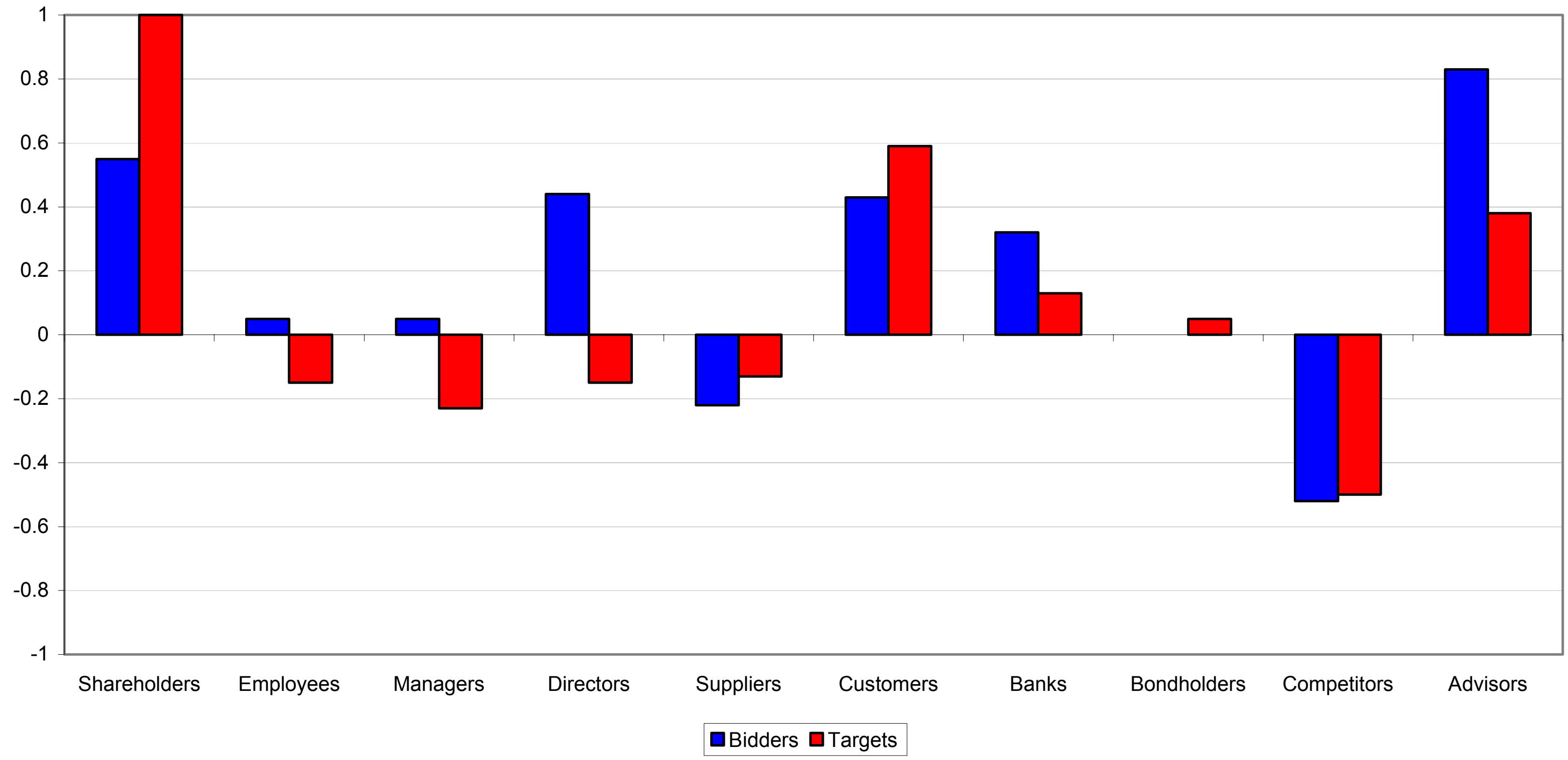


Table 3. *Effects of the merger on different groups*

Group		*Benefit %*	*No effect %*	*Lose out %*	*Cases*
Shareholders	Bidder	64.5	25.8	9.7	31
	Target	100.0	0.0	0.0	31
Employees	Bidder	19.0	66.7	14.3	21
	Target	23.1	38.5	38.5	26
Managers	Bidder	21.1	63.2	15.8	19
	Target	19.2	38.5	42.3	26
Directors	Bidder	50.0	44.4	5.6	18
	Target	30.8	23.1	46.2	26
Suppliers	Bidder	0.0	77.8	22.2	18
	Target	16.7	54.2	29.2	24
Customers	Bidder	43.5	56.5	0.0	23
	Target	63.0	33.3	3.7	27
Banks	Bidder	36.4	59.1	4.5	22
	Target	25.0	62.5	12.5	24
Bondholders	Bidder	0.0	100.0	0.0	18
	Target	10.5	84.2	5.3	19
Competitors	Bidder	4.8	38.1	57.1	21
	Target	4.2	41.7	54.2	24
Local community	Bidder	16.7	66.7	16.7	18
	Target	21.7	56.5	21.7	23
Advisors	Bidder	87.5	8.3	4.2	24
	Target	62.5	12.5	25.0	24

Figure 2. *The Mean Effect of Mergers on Different Groups*



In interviews we put the same question to company directors, lawyers, merchant bankers, institutional shareholders and employee representatives:

> Did directors' duties to consider interests of creditors and employees as well as those of shareholders affect the preparations for, the conduct of and the aftermath of the bid?

On the central question of directors' duties, the response was almost invariably that while directors might consider employees' and creditors' interests, the outcome of a bid was determined by shareholder value. Shareholder value took precedence over all other considerations. The responses to the question are separated out below by group, with advisers first, followed by directors, employee representatives, and institutional investors.

Comments from advisers were as follows. Some of these acknowledged a need to communicate to employees, but without exception they indicated that employees' interests play little role in the deliberations of directors during a bid. According to one interviewee, 'in a takeover situation, the duty to act in the interests of the company effectively means a duty to act in the interests of the shareholders of the time: not present and future. Section 309 of the Companies Act and General Principle 9 of the Code are not so important'. Another commented, 'the effect of General Principle 9 is that you are given permission to temper your pursuit of your shareholders' interests with your employees' interests. It is used as an argument but never really has an influence on the outcome'. More generally, there was widespread agreement that it was the duty of directors to deliver advice to shareholders on the valuation or valuations which they were being offered. A typical comment was as follows:

> Directors *do* consider employees' interests, but no-one really knows what that means. At the margin the touchy-feely things matter, but the board of directors, faced with 2 people offering £1 and £1.10 must go for the higher. The decision, of course, is not usually put like that, but I don't know of any cases where employees' interests have come first.

Aside from cases of companies in financial distress, when the position of creditors and employees would come under consideration, employees were only mentioned out of lip service to the obligation in rule 24.1 to state intentions with regard to the treatment of pre-existing rights:

> Directors’ duties to consider other interests are rarely an issue unless the company is near to insolvency. These clauses together are a bit of a sop. Rule 24 of the Code requires a statement of intentions towards employees, which always gets reduced to the standard phrase: ‘the bidder will ensure that all rights of the target employees will be met in full.’ Sometimes people do say more - sometimes a target will screw a stronger statement out of the bidder. And where companies intend not to make redundancies, they will tend to say it.

More pithily, ‘much is spoken about directors’ duties to employees, but it is rarely relevant’; in this context, ‘the Takeover Code and Companies Acts just muddle these issues up: directors have to recommend ‘the deal’ when they are really just recommending the price.’

Directors were also asked whether directors’ duties to consider the interests of employees, creditors and the company as a whole had influenced the company’s actions. Most expressed ignorance of this formulation of directors’ duties (‘[t]hese were not especially relevant in this case’) or considered such duties irrelevant (‘[w]e checked these, but there were none of any special relevance to this case’). In only a minority of cases was a role for consultation was acknowledged: ‘[t]here was consultation with employee representatives as soon as the merger was announced (both with trade unions and with staff associations)’. By contrast, several interviewees perceived a major role for directors’ duties, with the focus, generally, on shareholder interests. Advisers played a particularly important role in focusing attention on the financial aspects of a bid:

> The one thing that [our merchant bankers] kept saying was that ‘you have to be sure that when you say that a price is inadequate, you mean it and can back it up.’ Were we advised that we could take into account the interests of the company as a whole? No - the primary advice was that ‘there is a price at which you have to say yes.’

In addition, non-executive directors were identified as advocates for the shareholder interest, even where this meant dismembering the corporate enterprise:

> Were we advised of our legal obligations to our shareholders? Yes - there was lots of advice. One of the non-executive directors did push us hard to consider closure and selling up as

> an option to get maximum shareholder value (about 5 years before the bid).

Exceptionally, in one case where a utility company's future had been at stake, shareholders did not perceive their own financial interests to be the priority:

> [An American investment trust manager] arrived at the extraordinary general meeting at the City Hall and tried to explain why he was looking for shareholder value. He started by saying that he was a marine and that he had fought alongside the Royal Marines, or in Vietnam or some such, and that he invested funds on behalf of the widows and orphans of New York City. Well, he just got shouted down.

Institutional investors likewise thought that directors should be aware of their fiduciary and other duties during a bid. One was 'happy with the idea that directors owe duties to "the company" but was of the view that 'during a bid, especially, the directors understand this as being a duty to shareholders.' Another considered that for directors to perform according to their fiduciary duties, 'they had to show that it was in the interests of shareholders to sell'. The pursuit of stakeholder interests was not seen as a viable alternative to shareholder value:

> It is hard to make a case that [the duty further the interests of the company as a whole] affected the bid greatly. In principle a defending company might put employees' interests before those of shareholders but they are basically serving shareholders' interests first. If directors have a duty, it is to ensure that employees have marketable skills. I see directors' duties to employees as being more like pension rights protection than long-term employment safeguards.

Employee representatives were less clearly opposed to bids than might have been thought. Hostile bids were sometimes seen as shaking up incumbent managerial teams with which the employees had little by way of common interest. Hence employee representatives commented unfavourably on the tendency of target directors to be excessively well-rewarded even before bids, in pay and share options, and on the negative effect this had on the workforce:

> I was very concerned about the calibre of directors we had - most were engineers, or old civil servants and a few marketing

> boys parachuted in from outside. They were not always competent. One thing they all shared was great share packages. And when the bid came in, they were primarily motivated by the gains they would get. They were all close to retirement. In my view they allowed themselves to be bound, not to say various things. There were 2 weeks of phoney cold war, where the bid was hostile, followed by agreement after a raised offer.

A similar comment was as follows:

> Labour relations pre-bid were quite hierarchical, with the workforce quite isolated from the senior management. All the old electricity boards had a Chairman, Deputy Chairman, board, all way up there. When they were privatised, they appointed non-executive directors, who then set the salary levels for directors, who then reappointed the non-executive directors and in turn voted through their wages. Directors' salaries went up from £40,000 to £60,000 per year, to £140,000 to £215,000. That really upset the workforce, as did the share options for directors.

Particular criticism was reserved for the practice of linking managerial remuneration to the number of workers dismissed:

> The other thing that caused trouble was the directors' incentives schemes. They had a bonus system which had work completed according to certain targets divided by the number of staff that they employed to do it. So what they did was to sack a lot of staff, and employed outside contractors, to fulfil their conditions and increase their bonuses.

By contrast, relations with bidders were often good. There was evidence of informal consultation taking place. One employee representative reported getting tacit assurances about future plans from a future managing director in private meetings; another stated that he received non-specific but basically reliable undertakings about redundancy policies from the future management during the bid. The target management was more elusive. One union whose members worked for the target reported receiving repeated offers from an agency employed at several removes from the target for under-the-table funding for opinion polls about employees' and the public's view of a foreign bid. They turned this down. Meanwhile the union reported that the management of the target only once directly spoke to the union about the bid - whilst union members were picketing an EGM, one director quietly congratulated a union representative on the union's efforts to resist the bid. No formal consultation by target management with the union was carried out:

> Employees? They never came into it. I spoke to one [target] director once, on a picket line outside an extraordinary general meeting. He shook my hand and thanked me for all I was doing for shareholders. I told him I was doing it for employees. In general, as long as the new owner tells us that they intend to carry on as before, the directors feel that they've done their job. In reality, employees' interests (and differences in company practices) are not considered. [The target] directors never came to see us at all.

Strikingly, none of the employee representatives were convinced that a higher commitment from management to consultation would have materially affected the bids in which they were involved. In part this was out of a frank recognition that the decision was in the hands of shareholders and hence was 'purely a commercial thing'. The priority was to keep lines of communication open after the bid in an attempt to avoid compulsory redundancies and smooth the way of the new owners. This was a typical comment:

> We take the view now that we're not going to be able to prevent [the takeover] - so we try to get the best deal we can. Given the current industrial relations climate, I don't think that even a 'requirement to consult' would make much difference.

Several of the union respondents had been involved in bids for companies in the general utilities sector (water, gas and electricity). They were of the view that hostile takeovers had simply accelerated a wave of redundancies which had already been put in train within the industry. Several welcomed the new management team which had come in. In one case, *the* new team reintroduced union recognition arrangements which the target management had abandoned following privatization a few years previously. Another respondent highlighted the issue of the share options for the workforce as a whole, and the way that these had muted employee, management and union opposition to takeovers in their industries.

> We had to recognise that the higher the share price went, the better it was for our members who had shares. Some of them even had to get advice on how to sell their shares in a way which would minimise their exposure to capital gains tax.

> Union officials as much as anyone else were caught by the attractiveness of the bid, through the big share value rise and the generous redundancy packages that were on offer.

Some tentative findings can be drawn. For target directors, the nature of the advice they received was of paramount importance. During bids they saw their duty in terms of maximizing the potential value of the company as a financial asset of the shareholders. This obligation stood before any requirement to consult employees, to consider their interests, or to further the interests of the company as a whole. Even outside the bid period, the perceived 'duty' to focus on shareholder value could lead a non-executive director to see it as his role to force management to consider closing down the enterprise. Correspondingly, institutional investors applauded directors who saw their responsibilities in these terms.

The attitudes of employee representatives are best described as pragmatic. They expected little from target managers whose interests were seen to be tied up with share options and remuneration packages which would leave them better off whatever the outcome of the bid. There was no expectation of consultation with the target management, and no prospect of it making a difference to the outcome of the bid if it did take place. By contrast, the intervention of bidders could be seen in a positive light, particularly where there had already been a breakdown of trust with incumbent management. Informal links could be established with the bidder at an early stage, and a relationship constructed with a view to the future, even it was recognised on both sides that the most immediate issue was likely to be the management of redundancies.

5. Retrospective assessments of the outcome of mergers

The evidence we have so far reported concerns near-contemporaneous perceptions of the takeover process. The success or failure of takeovers must also be judged by the longer-term performance of merged firms. As we have seen, there is some evidence to suggest that hostile bids produce small but positive returns over time for shareholders, by comparison with negative returns in the case of agreed bids (Cosh and Guest, 2001). There is less evidence measuring the long-run effects of takeovers on employees and communities. There is US evidence to the effect that employees with firm-specific human capital who are displaced from employment by redundancy suffer long-term losses in earning capacity as a result (Schultze, 2001). However, this research does not separate out the effects of hostile bids from other causes of corporate restructuring.

Case studies, while not necessarily representative in the way that quantitative studies are, can nevertheless provide useful evidence on the dynamics of stakeholder relations post-takeover. Of the fifteen bids in our original sample, twelve led to mergers which could be meaningfully studied in this sense. We analyse their effects in two parts. First, we examine how far the takeovers in this sample led to job losses and short-term disposals. Secondly, by reviewing the informed opinion of analysts and the financial media, we assess whether the takeovers have been perceived to be successful from the point of view of creating value for shareowners.

5.1 Job losses and disposals of assets

The two key themes that emerge from a review of reports of events in our case study firms are, firstly, that in general takeovers are often followed by significant job losses, and secondly, that corporate activity is characterised by a short-term asset disposals.

Significant job losses followed several of the takeovers in our case studies. As a result of Glaxo's takeover of Wellcome 7,500 jobs were shed, 5,000 being lost in the first year following the takeover.[26] Furthermore, in October 1999, Glaxo Wellcome announced it was to shed a further 3,400 jobs, 16 per cent of its manufacturing workforce, as part of plans to slash annual costs by £370 million by 2003. Half these job losses were in the UK. According to the unions involved, there had been no prior consultation and it was 'a unilateral decision by an arrogant management'. Analysts suggested that the restructuring was welcome, but overdue, given overcapacity in manufacturing following the takeover.[27]

Another example is the announcement by Rhone-Poulenc of plans to eliminate 2,900 jobs from the 28,000 strong payroll by the end of 1997. The job cuts were intended be the most important contribution to savings of $200 million a year following the $4 billion acquisition of Fisons.[28] BIFU, the Banking Insurance and Finance Union, warned that the Lloyds/TSB merger, with its promised £350 million annual cost savings, would eventually mean that the then workforce of eight seven thousand would be cut by ten thousand. In April 1996 the bank announced 500 job losses at their head offices, and a further 3000 job losses in February 2000 which were directly related to the takeover. Harnischfeger's announcement in 1998, that it was axing 3100 jobs, or 20% of the workforce, is yet a further example of significant job losses in our case study firms.[29]

As well as significant job losses, several of the case studies also demonstrate a strategy of short-term asset disposal rather than a strategy of growing the entire acquired business over the long term. Some takeovers were clearly aimed to produce disposals and hence value in the short term. A key element of Granada's strategy for the takeover of Forte was the proposed disposal within six months of Forte's Exclusive and Meridian hotel chains for £1.6 billion. More striking is the full demerger of Eastern Group from Hanson in February 1997, less than two years after the original takeover.

Southern's takeover of SWEB further illustrates this point. Less than twelve months after acquiring SWEB, Southern Company sold a 25% interest to another US utility company, and this was later increased to a 49% interest. Southern said this deal was beneficial to shareholders as it realised a small premium on its investment and in any case it was part of its normal strategy of finding minority partners for overseas acquisitions. However, in June 1999, Southern went a stage further and sold SWEB's power supply business.[30] Again, this was argued to be beneficial Southern shareholders as EDF, the French utility company, paid a price above analysts' expectations. At the same time the sale was seen as a response to tough regulatory price controls and the Government imposed windfall tax, which were said to have cost almost two years of SWEB's earnings. Furthermore, in 1999 Southern's chairman acknowledged that SWEB was not the type of investment that they would make again as it did not fit into their overall strategy of developing the supply business in Continental Europe.

The Lloyds/TSB and Rhone-Poulenc/Fisons deals are further examples of takeovers characterised by asset disposals. They also suggest that so-called undertakings made during the couse of a bid tend to disregarded later. Within six months of giving written assurances of continuing employment to the staff of Hill Samuel merchant bank, Lloyds set about dismantling it, leaving six hundred staff facing redundancy. Although Lloyds said this was a useful benefit to shareholders as they had preserved a substantial part of the revenues but removed a considerable proportion of the costs, the *Financial Times* considered that 'the crushing of Hill Samuel Bank has more significance than it represents for the dividends of Lloyds-TSB investors.' According to another commentator, Hill Samuel had been 'blown apart by people who do not know what they are doing.'[31] The Fisons deal left Rhone-Poulenc in a highly leveraged position. In the light of analysts' comments that the deal had set Rhone-Poulenc back two years in terms of getting its balance sheet sorted out, it was little surprise that in June 1996 Fisons' US businesses were sold for £263 million. However, the sale was regarded by analysts as a short-term response in the sense that these assets had been considered likely to be value enhancing for Rhone-Poulenc.

5.2 Variable success in creating shareholder value?

Notwithstanding attempts to raise value for shareholders from short-term disposals, there is evidence that, over the medium term which our study is able to take (five-six years from the merger), even hostile takeovers are in general not perceived as value enhancing for the shareholders of the acquiring companies. We will focus here on one particularly prominent case, Granada's £3.9 billion takeover of Forte. Lauded at the time of the takeover, five years on this deal was seen, generally if perhaps controversially, to have failed to enhance shareholder value. In 2001 a *Financial Times* analysis suggested that 'the returns for Granada have barely matched the group's cost of capital and that its shareholders might have been better off if the deal had never been done.'[32] Total disposal proceeds were estimated to amount to £5.059 billion, while Travelodge and Little Chef, which had not been sold, were generously estimated to be worth £1.5 billion. Entering these figures into a discounted cash flow model gave a present value of £5.327 billion, just £10 million more than the total acquisition cost including debt of £5.317 billion. Another way of looking at the figures suggested that the internal rate of return was 8%, or roughly in line with estimates of Granada's weighted cost of capital, suggesting that the deal was at best neutral for Granada shareholders. However, investment analysts were also of the view that if a more realistic valuation of £1 billion was applied to Little Chef and Travelodge 'the takeover would appear to have destroyed value'.[33] The *Financial Times* analysis also argued that although the deal destroyed value for Granada shareholders, as a result of the takeover being so well defended '[u]nquestionably the Forte shareholders were the winners because of the massive upfront premium paid.' The *Financial Times* suggested that the advisers to the deal were also clear winners, as they received an estimated £250 million in fees.[34]

Similarly, the £9 billion acquisition of Wellcome by Glaxo came to be perceived as having to have done little to enhance shareholder value. By August 1997 the *Financial Times* was declaring that, 'Glaxo Wellcome is destroying shareholder value at the moment.'[35] The same article suggested that in five years' time the company would be creating more value than any other European drug stock. This was because newly launched treatments for asthma, Aids and migraine would most likely replace the loss of sales resulting from the expiry of the US patents for its top selling Zantac and Zovirax products. However, this prediction proved to be excessively optimistic. In July 1999, Glaxo formally abandoned its double-digit growth target, and 11 per cent was knocked off the share value.[36] From the beginning of the year Glaxo underperformed the FTSE 100 Index by 24%, making it the index's tenth worst performer.[37] By the end of 1999 analysts described Glaxo's performance as 'pedestrian'[38] and Glaxo's 1999 results showed underlying pre-tax profits up just 5 per cent, compared to 11% earnings growth reported by SmithKline, with which Glaxo was then in the process of merging. Moreover, without disposals Glaxo's profits would have been virtually level with the previous year, while annual sales were up just 5% compared to SmithKline's 10 per cent.[39] All of this meant that in comparison to SmithKline, Glaxo had looked 'rather sickly' over the previous couple of years.[40] The key problem for Glaxo was the withdrawal of three new drugs on safety grounds and the disappointing launch of a new flu drug. In answer to its own rhetorical question: 'What has gone wrong at Glaxo Wellcome?' the *Financial Times* concluded that the 'uncomfortable answer seems to be that the company became seduced by the glamour of innovation to the detriment of its core competence: commercial savvy.'[41]

Other takeovers in our sample, such as the Rhone-Poulenc/Fisons and Lloyds/TSB deals, by contrast were reasonably successful at creating value for owners of shares in the acquiring company, but only in the short to medium term. At the beginning of 1996 the *Financial Times* said that a profits warning from Rhone-Poulenc had become almost an annual event [42] and that it had long been 'the most unloved of pharmaceutical companies.'[43] However, during the year net income increased by 28 per cent, earnings per share increased 26 per cent, dividends increased by 17 per cent[44] and the share price increased by 50 per cent. Analysts argued that as well as the re-rating of the whole pharmaceuticals sector and the benefit of a number of favourably received new products, the takeover of Fisons had been a key factor. Not only were costs savings starting to come through but the deal had also acted as a catalyst to develop a clearer focus so that ' the effect induced by Fisons was almost as important as Fisons itself.'[45] Nevertheless, despite the apparent success of the Fisons deal, growth was said to be lower than for other drugs companies and the company felt its stock was undervalued. In June 1997, driven by the aim of increasing the stock market valuation and price/earnings ratio for the entire group, Rhone-Poulenc restructured by splitting itself into a life sciences company and a chemicals business. Even at the time of this announcement the company and its financial adviser were suggesting that the best way for it to achieve its targeted price/earnings ratio was to do a deal with another chemicals company, similar to the merger between Sandoz and Ciba to form Novartis.[46] In 1999, this came to fruition when Rhone-Poulenc agreed to merge with Hoechst, the German pharmaceuticals and chemicals company, to form a new company called Aventis, the world's biggest life sciences company. Although a full merger was originally planned over three years the deal was brought forward and was completed by the end of 1999. This was due to the insistence of a 25 per cent shareholder in Hoechst that shareholder value should be boosted as quickly as possible.[47]

The financial media also rated the Lloyds TSB deal was a success in creating shareholder value. In December 1996 analysts said that Lloyds TSB 'is and will remain by far the most profitable UK bank.'[48] The Financial Times put this down to two key advantages. First, the £400 million of annual cost savings from the TSB merger, most of which were still to flow through and which would eventually be achieved in 1999. Second, its heavy weighting towards high-margin retail lending.[49] Indeed the group was said to have set new standards of profitability, delivering to shareholders return on equity of 33% in 1996, and 37% in 1997 [50] However, even the Lloyds TSB story is not one of continual progress. By 2000 the Financial Times was reporting that shares had underperformed the market by 35% since their peak in the summer of 1998. Although it was still trading at 3.5 times book value, against a sector average of just 2.5 times, the premium was narrowing.[51] Lloyds had acquired a reputation for extracting costs and synergies from mergers, which had left it with one of the lowest cost-income ratios in the industry and a return on equity above 30 percent. The problem, according to the *Financial Times*, was that fashions change and investors increasingly preferred banks with international growth strategies.[52] Lloyds needed to convince investors it could grow revenue faster than its rivals. But, according to the *Financial Times*, Lloyds' record here had been less impressive. Lloyds' revenues had grown at about 6 per cent a year over the last decade, against 4-5 per cent for Barclays and National Westminster. [53] Lloyds' stock market rating had fallen below competitors able to offer the prospect of top-line growth, such as HSBC, which had been buying aggressively in Europe and America. The result of this was Lloyds' prolonged and very expensive bid for Abbey National, which ultimately failed on competition grounds in the course of 2001.

One conclusion to be drawn from the Rhone-Poulenc and Lloyds cases is that even where a takeover initially appears to have been successful in creating shareholder value, this is insufficient to satisfy investors over the medium to long term. As a result the companies have had to engage in further corporate activity in order to satisfy demand for even greater returns. However, it is also clear that corporate restructuring that is driven by a desire to enhance shareholder value can have an entirely opposed effect. This point is also illustrated by the case of GEC. It is particularly difficult to assess the impact of GEC's takeover of VSEL on shareholder value, given GEC's highly complex corporate structure. However, following the takeover VSEL seems to have made steady progress and won several shipbuilding contracts. At the time of the takeover the *Financial Times* commented that the takeover made little sense apart from GEC preventing VSEL falling into the hands of BAe and so leaving BAe vulnerable to a takeover by GEC. However, following the succession of a new managing director, and in pursuit of a new strategy of specialising in telecommunications and electronic systems, GEC sold the whole of its defence business to BAe in 1999. At the end of 1999 the *Financial Times* was lauding this new strategy. It said the former GEC, now renamed Marconi, was beginning to look like the high technology and high margin growth story promised to shareholders and that it had outperformed the market by 40% since the start of the year.[54] However, the result of this corporate restructuring, designed to enhance shareholder value, was ultimately the destruction of shareholder interests as financial disaster hit Marconi in 2001, in the wake of the severe slowdown in the high technology sector. In the summer of 2002 the company had to be rescued by a consortium of banks, leaving shareholder interests virtually valueless.

6. Conclusions

At first glance, company law recognises the multi-stakeholder nature of the firm and the cooperation problem which it engenders: in order for the firm to flourish as a productive enterprise, the open-ended commitment of the different stakeholders is required. This cannot be completely contracted for ex ante, so a space is created for implicit contracts and similar informal mechanisms of governance to come into play. The legal framework has a role to play in providing an environment in which sustained cooperation is feasible. Directors' fiduciary duties are phrased in such a way as to make it possible for management to take into account of the interests of multiple constituencies; 'enlightened shareholder value' provides a focal point for multi-stakeholder coordination. In principle, then, the law allows management to mediate, ex post, between the different implicit contractual claims of the various groups whose input is needed to make the corporate enterprise possible.

The hostile takeover, by contrast, is a mechanism aimed at enhancing the accountability of corporate managers to just one constituency – shareholders (or, more precisely, shareholders in the target). This is particularly so in the UK context, where the self-regulatory norms governing takeover bids, mainly derived from the City Code, combined with certain well-established practices (such as pressure to maintain pre-emption rights), impose a particularly strong form of the managerial passivity rule. This is in contrast to the 'auction' orientation of US law and practice, which allows some leeway for takeover defences, and the more clearly pro-stakeholder approach of the recent German takeover law. In the UK, there is no adequate mechanism for the expression of employee voice during the takeover process (in contrast to the position in respect of restructurings carried out through a business transfer: see Armour and Deakin, 2002). Once a bid is launched, target management's concerns are focused on the short-term, financial interests of the shareholders. In effect, the open-ended fiduciary duty to act in the best interests of the company becomes a much more precise obligation to have regard to the interests of the shareholders in getting the best price for their shares. As a result, there is no firm basis on which implicit contracts with non-shareholder constituencies can be maintained.

The long shadow cast by the City Code in this process is crucial. The Code is the consequence of the mobilisation of a collective interest on the part of institutional shareholders and financial professionals. The empirical evidence reported here suggests that those involved most immediately in takeover bids – directors, advisers and institutional investors – view the Code as the most important regulatory factor influencing bid process. We also saw that almost all participants, including employee representatives, see target directors as acting in the short-term, financial interests of target shareholders, and that directors are also seen as being unable to take into consideration employees' interests in continuing job security.

The studies of post-bid performance demonstrate the range of possible trajectories for companies in the post-bid period. Since the sample is non-random, these studies are illustrative only. However, it is striking that in many cases, measured by the standard of investor opinion, merged companies were struggling to live up to the expectations of the investment community at end of the 1990s. This raises fundamental questions about the manner in which the market for corporate control currently operates in the UK. Target shareholders, who effectively decide the outcome of a bid, may cede control in return for a premium over the market price of their shares. Bidder shareholders, by contrast, have little or no opportunity to hold management to account. Disenchantment ex post with the outcome of bids is a sign evidence of inadequate accountability ex ante between managers and shareholders in bidder companies. In addition, the prioritising of financial interests over production interests during bids prevents managers respecting implicit contracts with non-shareholder constituencies, exposing their interests to expropriation in the form of the asset disposals and redundancies which almost routinely follow hostile takeovers. It would be surprising if this practice had no effect at all on the willingness of employees and suppliers to make firm-specific investments in human capital and the joint development of products and services. Further research along the lines indicated in this paper may be able to tell us more about the potentially negative influence of the

Takeover Code on UK productivity and competitiveness, and about the possible repercussions of extending that model throughout the European Union via the Thirteenth Directive.

Notes

[1] In particular in *Unocal Corp*. v. *Mesa Petroleum Co.* 493 A.2d 946 (1985), discussed further, below.

[2] (1843) 2 Hare 461.

[3] City Code on Takeovers and Mergers, General Principle 1.

[4] Ibid., rule 9. Also relevant here are Companies Act 1985 s. 430A providing a statutory right to sell where where the bidder and its associates control 90% in value of the relevant shares, and Companies Act 1985 s. 428 on the bidder's right of compulsory purchase of the last 10% of shares.

[5] City Code on Takeovers and Mergers, rule 20.1.

[6] Ibid., rule 3.1.

[7] Ibid, rule 25.1.

[8] Ibid., rule 19.2.

[9] Ibid., General Principle 9.

[10] Ibid., rule 24.1.

[11] Section 309 has given rise to a rather patchy and inconclusive case law, which mainly turns on whether this provision can be used by directors to deflect possible claims for breach of fiduciary duty brought by disgruntled shareholders (see Parkinson, 1993). Because employees have no standing to enforce the obligation apparently imposed for their benefit by section 309, it is not surprising that its only practical use to date has been to protect managers against shareholder-led litigation, thereby lending weight to the charge that section 309 and the US stakeholder statutes are merely manager-entrenchment devices (see Robilotti, 1997).

[12] Ibid., rule 21.

[13] *Howard Smith Ltd.* v. *Ampol Petroleum Ltd.* [1974] AC 821; Parkinson, 1993: 143.

[14] The Responsibility of Institutional Shareholders in the UK 1991, at p. 5; Davies, 1993: 86.

[15] Companies Act 1985, ss. 85-89.

[16] *Unocal Corp*. v. *Mesa Petroleum Co.* 493 A.2d 946 (1985).

[17] *Revlon Inc*. v. *McAndrews & Forbes Holding Inc*. 506 A. 2d 173 (1985). See also *Smith* v. *Van Gorkom* 488 A.2d 858 (1985) in which, exceptionally, the business judgment rule failed to protect a board which decided to favour one bid over another. The crucial factor here appears to have been the potential conflict of interest in the role of the company's own CEO in promoting the adopted bid.

[18] See in particular, *Paramount Communications Inc.* v. *Time Inc.* 571 A.2d 1140 (1990); *Paramount Communications Inc.* v. *QVC Network Inc.*

637 A.2d 34 (1993); *Unitrin Inc*. v. *American General Corporat*ion 651 A.2d 1361 (1995). For discussion see Blair, 1994; Black and Kraakman, 2002; Kahan and Rock, 2002.

[19] The potential role of state-level stakeholder statutes, and the constitutional jurisprudence surrounding them, should also be noted in this context (see Orts, 1992; Mitchell, 1992; Njoya, 2002).

[20] See *First National Maintenance Corp* v. *NLRB* 452 US 666 (1981).

[21] These are found in, respectively, the Trade Union and Labour Relations (Consolidation) Act 1992, section 188 et seq. (implementing the EC Collective Redundancies Directive, 98/59/EC), and the Transfer of Undertakings (Protection of Employment) Regulations 1981 (implementing the EC Acquired Rights Directive, 2001/23/EC). See generally Armour and Deakin, 2002.

[22] The correct reading of the Acquired Rights Directive is almost certainly that it has no application to mergers by share transfer, for the reasons examined in Armour and Deakin, 2002.

[23] See COM (2001) 77 final.

[24] See the European Parliament Daily Notebook, 4 July 2001: (http://www.europarl.eu.int/press/index_recherche_en.htm). For the recent history of the draft Directive, with references to relevant texts and official documents, see http://europa.eu.int/prelex/detail_dossier_real.cfm?CL=en&DosId=11887#322077.

[25] In a small number of cases, it was not feasible to conduct a study of the impact of the bid either because no merger resulted from it or because the subsequent history of the merged company made it impossible to trace the effects of the bid.

[26] *Financial Times*, 8 September 1995

[27] *Financial Times*, 6 October 1999

[28] *Financial Times*, 30 January 1996

[29] *Financial Times*, 27 August 1998 However, the Harnischfeger job losses may have been more directly related to the company's dire financial position, than to the takeover of Dobson Park.

[30] SWEB's distribution business was retained.

[31] *Financial Times*, 5 September 1996

[32] 'Forte bid short-changed the Granada investors', *Financial Times* 29 May 2001

[33] Ibid.

[34] However, the *Financial Times* did point out that the issue of whether the deal created value for Granada was far from clear cut, because Granada made material improvements in the operation of the assets and pace of value realisation. It can also be argued that Granada

needed a hospitality acquisition to build up that side of the business with the aim of splitting it off from its media business, as has now been achieved. Moreover, the deal can be seen as being driven by earnings considerations, achieving earnings enhancement of 10% in the first full year of ownership. This helped bouy Granada's share price, which performed in line with the FTSE 100 Index in the period 1996-2001.

[35] *Financial Times*, 1 August 1997
[36] *Financial Times*, 30 July 1999
[37] *Financial Times*, 20 July 1999
[38] *Financial Times,* 18 November 1999
[39] *Financial Times* 17 February 2000
[40] *Financial Times*, 28 July 2000
[41] *Financial Times*, 4 December 2000
[42] *Financial Times*, 10 January 1996
[43] *Financial Times*, 30 January 1996
[44] *Financial Times*, 31 January 2001
[45] *Financial Times*, 19 November 1996
[46] *Financial Times*, 27 June 1997
[47] *Financial Times*, 17 March 1999
[48] *Financial Times*, 5 December 1996
[49] *Financial Times*, 27 July 1996
[50] *Financial Times*, 23 June 1999
[51] *Financial Times*, 12 February 2000
[52] *Financial Times*, 7 December 2000
[53] *Financial Times*, 12 February 2000
[54] *Financial Times*, 26 November 1999

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