

HOSTILE TAKEOVERS, CORPORATE LAW AND THE THEORY OF THE  
FIRM

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Simon Deakin  
ESRC Centre for Business Research  
Department of Applied Economics  
University of Cambridge  
Sidgwick Avenue  
Cambridge CB3 9DE

Phone: 01223 335242  
Fax: 01223 335768  
Email: [sfd20@econ.cam.ac.uk](mailto:sfd20@econ.cam.ac.uk)

Giles Slinger  
ESRC Centre for Business Research  
Department of Applied Economics  
University of Cambridge  
Sidgwick Avenue  
Cambridge CB3 9DE

Phone: 01223 335258  
Fax: 01223 335768  
Email: [gs10010@econ.cam.ac.uk](mailto:gs10010@econ.cam.ac.uk)

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## **Abstract**

This paper assesses the impact of the regulatory system governing takeovers and considers the relevance of economic theory for the design of corporate law and governance systems. We find that the institutional framework in the UK both discourages defences against takeover bids and protects the interests of target shareholders above those of other 'stakeholder' groups during bids. Compelling evidence regarding the eventual sources of gains justifying the premiums paid in hostile takeovers to target shareholders is difficult to find. In the absence of such evidence we question the absence of compelling evidence that hostile takeovers result in superior long-run performance by firms, we question whether a system of company law which aims at maximising shareholder value in this way is compatible with society's interest in maintaining an efficient corporate sector.

# HOSTILE TAKEOVERS, CORPORATE LAW AND THE THEORY OF THE FIRM

## Introduction

The legal treatment of hostile takeovers<sup>1</sup> is a central issue in the contemporary debate on corporate governance. In the 1980s, hostile takeovers came to be regarded as a mechanism both for raising shareholder value and for enhancing the efficiency of the corporate system as a whole. Two main effects were imputed to hostile bids. Firstly, the threat of an unwelcome bid served to improve the performance of incumbent managers and to align their interests more completely with those of shareholders. Secondly, hostile bids, even where they were not successful, tended to induce corporate restructurings which in turn freed up productive resources to be reallocated to more efficient uses elsewhere in the economy. In order to realise these ends, the fostering of an active market for corporate control was seen as one of the principal goals of company law.

More recently, this view has been challenged by the 'stakeholder' model which sees hostile takeovers as occasions for the redistribution, rather than the generation, of wealth. The gains made by shareholders are said to accrue not from greater efficiency in the management of assets, but from income transfers made at the expense of the long-term employees, suppliers and customers of the firm. The threat of such expropriation undermines co-operation within the productive process and thereby threatens long-run competitiveness. Views of this kind informed the adoption of 'stakeholder' or 'constituency statutes' in many US jurisdictions in the late 1980s and early 1990s but, as yet, have had little impact on the British debate.

The legal framework of corporate law - broadly conceived to include not just company law but also elements of labour law, commercial law and the law of taxation - is more immediately concerned with the definition of the property rights and income streams of those with interests in or against the business enterprise, than with considerations

of economic efficiency. Economic arguments may nevertheless provide a powerful justification for, or critique of, corporate law systems. The argument that it is the purpose of a given branch of the law to defend the interests or rights of one group as opposed to another can, in the end, only take us so far. It is of limited assistance, for example, in determining when shareholders' interests should be qualified by those of, for example, employees or creditors. In practice, shareholders' property rights are rarely unqualified; they depend on the state of company law and corporate governance within particular national systems, and they vary considerably according to differences in company structure, conceptions of directors' duties, and the specific regulation of takeover activity. It is largely because there is no one 'natural' model of shareholder rights that attention has focused on the implications of different systems for economic efficiency.

It is in the context of this debate that the present paper makes an assessment of the competing economic theories of the corporation, with particular reference to the regulation of takeovers. We firstly contrast the contractarian model to a loosely-related group of theories (including the 'stakeholder', evolutionary and competence-based models) which maintain that the essence of the firm as a productive entity cannot be fully captured by a contractual analysis. Next we examine how far legal conceptions of the corporation and, more specifically, of the takeover process, offer support for the different economic models. The focus here is on the UK Takeover Code and related aspects of company law, the broad features of which are contrasted to those of the US and German systems. This is followed by an evaluation of the available empirical evidence (which is mainly north American) on the efficiency effects of takeovers. The concluding section considers the relevance of economic theory for the design of corporate law and corporate governance.

## **Economic Theories of the Corporation**

### **The contract model**

The notion of the corporation as a 'nexus of contracts' is a development from Coase's initial insight into the firm as a means of economising on

transaction costs (Coase, 1937). However, where Coase saw the firm as 'superseding' the price mechanism, suggesting that the firm was an alternative to the market as a mode of economic co-ordination, the line of thought initiated by Jensen and Meckling has maintained that 'it makes little or no sense to try to distinguish those things which are "inside" the firm (or any other organisation) from those which are "outside" of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output' (Jensen and Meckling, 1976: 311). 'Contracts' are understood here in a broad sense as 'vehicles for exchange' (ibid.) and not necessarily as express agreements or as agreements which are legally binding. The function of contracts, so defined, is to provide incentive structures which serve to align the interests of the owners of the various inputs and to reduce information and monitoring costs which would otherwise distort the process of exchange.

According to agency theory, information costs are present in relationships where one party (the agent) acts on behalf of another (the principal).<sup>2</sup> The principal may not be in a good position to monitor or observe the qualities of the agent prior to entering into the contract or his or her performance during it.<sup>3</sup> Monitoring problems are inherent in the firm, affecting, in varying degrees, the relationships of shareholders and of creditors to senior managers, and of managers to other employees. The complexity of contracting and the diversity of interests involved in the process of production are such that a distinctive governance structure - the corporation - is needed in order for production to take place at least overall cost. However, this is best thought of 'like the behavior of a market; i.e., the outcome of a complex equilibrium process' (Jensen and Meckling, 1976: 311).

More specifically, the purpose of the corporation, as a 'legal fiction', is to provide a 'focal point' for contracting within a framework set by the rules of corporate law, which are understood as a set of standard terms or default rules for the governance of risk in various contractual settings. From this perspective, the separation of ownership and control

in the large, publicly-held or 'open' corporation is not a cause for concern in the Berle and Means tradition, but the product of a search for greater contractual efficiency (Fama and Jensen, 1983: 301). Indeed, in taking this view agency theory questions whether shareholders should be seen as the owners of the corporation in the first place. The firm, being no more than a set of contracts, cannot be owned by anybody, any more than a market could be (Fama, 1980: 288). But this does not mean that the shareholders should not be vested with *other* significant property rights which, under corporate law, are normally attached to the ownership of common voting stock. These include rights to certain income streams, such as rights to dividends based on profits and the right to any surplus left on a winding up, and rights to call management to account, rights which are exercised by voting at general meetings and by the sale of shares to third parties. The shareholders hold a particular position, then, as the 'residual claimants' to the income generated by the firm, which provides them with both the opportunity and the incentive to act as monitors of managerial behaviour.<sup>4</sup> It is this characteristic allocation of property rights between shareholders and managers (and, by extension, other employees and other 'stakeholder' groups) which the contractarian model seeks to explain and justify.

This is done by arguing that the separation of residual claimants (shareholders) from decision-makers (managers) in open corporations is efficient because of its contribution to a more highly specialised division of labour and to a more extensive diversification of risk. Corporate law does not require individual shareholders to take a role in the direction of the enterprise, any more than it requires employees to put up capital as a condition of being employed in the business. In the absence of a rule requiring shareholders to become managers or other employees, they can diversify their risk by maintaining holdings in more than one company. Conversely, managers can be chosen (and subsequently monitored) for their specialised skills in coordination and in labour-supply, and not in their capacity as investors (Fama and Jensen, 1983: 306). Other aspects of company law are relevant here. Limited liability, by restricting the potential losses of each shareholder

in the event of company failure to the nominal value of their shares, reduces the need for monitoring between shareholders; the wealth of individual shareholders, and indeed their precise identity, becomes irrelevant to their capacity to bear the risk of meeting future losses (Halpern, Trebilcock and Turnbull, 1980: 117). More generally, limited liability, coupled with the principle of the alienability of shares, makes possible the existence of a capital market in which shares trade at a price which reflects present estimates of the future value of the company, without regard to the wealth or other characteristics of its shareholders (Easterbrook and Fischel 1991: 42-43). The company's share price thereby provides a benchmark for evaluating the performance of management in enhancing the worth of the business.

The contractarian model sees the hostile takeover as a particularly important device for reducing monitoring costs. If the tenets of the efficient capital market hypothesis are accepted, the stock market is seen as capable of processing all available information about the value of a company's stock at a given time. The market's judgement that a particular managerial team is performing poorly will therefore be reflected in a depressed share price for that company, relative to the market as a whole. This, in turn, provides a takeover bidder with the opportunity to launch a bid (a 'tender offer') for a controlling block of shares in the target. Although bidders normally have to pay a significant premium over the pre-bid market price in order to gain control, these costs can be recouped, following a change of management, by putting the assets of the business to better use. Where a tender offer results in a change of control, all parties potentially benefit: 'the target's shareholders gain because they receive a premium over the market price. The bidder obtains the difference between the new value of the firm and the payment to the old shareholders. Non-tendering shareholders receive part of the appreciation in the value of the shares' (Easterbrook and Fischel, 1991: 173). Equally, shareholders in firms which are not the subject of takeover benefit because their own managers have incentives to improve company performance and raise the price of its shares in order to stave off unwelcome bids.

Wider benefits are also anticipated from the role of the market for corporate control in inducing the efficient reallocation of productive assets, particularly away from declining industries (Jensen, 1988: 21). Long-established firms are constrained by 'managerial and organisational defensiveness that inhibits learning and prevents managers from changing their model of the business' (Jensen, 1993: 849). Managers may be tempted to use the 'free cash flow' generated by earlier success to subsidise failing operations. The threat of a takeover which will lead to the break-up of the disparate parts of the company and direct surplus cash to the shareholders provides an external 'shock' of the kind which is needed to deter managerial waste.

Advocates of an active market for corporate control see it as important partly because of the ineffectiveness of internal corporate control mechanisms. It is suggested that internal monitoring, even by large, institutional shareholders is costly because of free rider problems: the gains from any improvements will be distributed among shareholders as a whole but only those who act to bring pressure to bear on management will bear the costs of doing so (Easterbrook and Fischel, 1991: 172). Even if the normal limits on collective action can be overcome, it may be impossible to identify accurately the individuals within a managerial team who are under-performing. For this reason, the hostile takeover bid, which often results in the near-complete displacement of one management team by another, is an effective device for improving the performance of the team as a whole (Easterbrook and Fischel, 1991: 172). It is also more effective, for the same reason, than the threat of external competition from the labour market for managers. The hostile takeover can be thought of, in this context, as a process by which managerial teams bid to take over the running of corporate assets (Jensen and Ruback, 1983: 5).

It follows that an efficient system of company law would be one which encouraged incumbent management to adopt an attitude of neutrality or passivity when faced with a hostile bid. At best, company law might either allow or require the target directors to respond to a takeover bid in such a way as to encourage an auction between one or more bidders,



which would result in the shareholders obtaining a higher price and, conceivably, in the resources in question being allocated to a more efficient use.<sup>5</sup> It is not clear whether this 'auction model' should, in principle, be preferred to one of complete passivity; Easterbrook and Fischel have argued that an auction rule would simply transfer gains from shareholders in the bidder to those in the target, without increasing efficiency. The transfer would, at the same time, discourage bids by raising their costs, and so would reduce the incentives on managers to maintain efficient levels of performance (Easterbrook and Fischel, 1991: ch.7). Easterbrook and Fischel are at one with their critics, however, in condemning the adoption by prospective targets of takeover defences aimed at frustrating hostile bids altogether, on the grounds that this raises monitoring costs and entrenches inefficient management.<sup>6</sup> The debate over the auction rule is between different branches of the contractarian school, and does not involve any fundamental disagreement in approach or methodology to the understanding of the firm.

The need for specialisation between suppliers of different inputs and the monitoring problems to which it gives rise may help to explain many features of corporate structure, but it does not in itself explain why monitoring should be vested in the shareholders, as opposed to other suppliers of inputs such as the employees. Why not have labour monitor capital? The answer generally given is that the shareholders bear the residual risk of the failure of the enterprise, and that it is appropriate, therefore, for them to be allocated the residual rights to the income flows generated by production. They are entitled to what is left from the income stream after the contractual claims of employees, commercial creditors and others have been met. Whereas wages and payments to creditors are normally fixed contractually, regardless of the level of profits recorded by the firm,<sup>7</sup> the shareholders' residual is directly linked to the firm's performance as reflected in its share price. The variability of the income stream flowing to shareholders provides them with the necessary incentives to monitor the behaviour of the other participants in the productive process. As Fama and Jensen put it (1983, pp.202-203):

The residual risk - the risk of the difference between stochastic inflows of resources and promised payments to agents - is borne by those who contract for the rights to net cash flows...Having most uncertainty borne by one group of agents, residual claimants, has survival value because it reduces the costs incurred to monitor contracts with other groups of agents and to adjust contracts for the changing risks borne by other agents. Contracts that direct decisions toward the interests of residual claimants also add to the survival value of organisations. Producing outputs at lower costs is in the interests of residual claimants because it increases net cash flows, but lower costs also contribute to survival by allowing products to be delivered at lower prices.<sup>8</sup>

However, this argument is essentially circular. In the context of the corporation, it is equivalent to arguing that shareholders bear the residual risk *because* company law makes them the residual claimants. It is necessary to go further, and show that shareholders are inherently *more* exposed to risk than other owners of inputs, before the structure of the corporation can be adequately explained on economic efficiency grounds. It is precisely this idea which is challenged by theories of production which in various ways see the firm in terms of organisational processes which are distinct from those of the market.

### **The firm as a productive entity**

To a non-economist, to say that the essence of the firm lies in its capacity to produce goods and services is to state the obvious. The contractarian approach cannot be accused of lacking a theory of production (Alchian and Demsetz, 1972), even if most of its major contributions lie in the field of finance. Rather, the essence of the critique mounted by 'competence-based' and evolutionary theories is that the organisation of production cannot be adequately understood by analogising the firm to the market, as agency theory does.<sup>9</sup> While the firm may well be a focus for complex contractual relations, it is much more than that. Firms are organisations in which value lies in distinctive processes, routines and interactions between economic agents which

cannot be completely contracted for and in many cases cannot be made the subject of a market exchange. Although the firm responds to external market signals in its pricing of inputs and outputs, its management also has an area of autonomy from immediate market pressures in which it can exercise strategic judgement and choices about the firm's direction. As a result, the growth of firms is largely generated internally through organisational development, rather than through a process of automatic adjustment to their external environment.

The idea that individual firms possess distinctive assets, which in the modern literature are referred to as 'competencies' or 'capabilities', is not new; it has a long tradition in the analysis of the division of labour which goes back at least to Adam Smith and which received a systematic treatment in Marshall's account of industrial organisation (Foss, 1993: 127; Hodgson, 1997). More recently, the idea has been revived in the study of 'strategic management' to explain evidence that firms within the same industry, and facing similar market conditions, tend to adopt differing strategies for achieving survival and growth, with the result that there are wide intra-industry variations in profit rates (Prahalad and Hamel, 1990: 79; Hamel and Prahalad, 1993). The essential feature of a 'capability' is that its value as a resource depends upon its being put to use over time within the organisational setting of the firm. As a result, capabilities cannot simply be bought in; they cannot be accurately priced by the external market. In this vein, Teece and Pisano suggest that 'the competitive advantage of firms stems from dynamic capabilities rooted in high performance routines, embedded in the firm's processes, and conditioned by its history. Because of imperfect factor markets, or more precisely the non-tradability of "soft" assets like values, culture and organisational experience, these capabilities generally cannot be bought: they must be built' (Teece and Pisano, 1994, 553). This is said to be the case, in particular, with regard to the managerial or entrepreneurial function of co-ordinating the different inputs within production (Foss, 1993)<sup>10</sup> but the analysis could equally well be extended to the acquisition by employees in general of firm-specific skills which depend on tacit or non-codifiable knowledge,

transmitted through learning by doing and enterprise-based training (Penrose, 1959: 53; Streeck, 1992).

The evolutionary theory of the firm takes this idea a step further to argue that 'competencies within the firm are both context-dependent and organically related to each other' (Hodgson, 1997). The firm's resources, in other words, amount to more than the sum total of the resources which are owned by or at the disposal of its individual members (whether they be shareholders, employees or third party contractors). It is in this context that Nelson and Winter have argued that the firm possesses an 'organisational memory' which is replicated through its routines: 'to view organisational memory as reducible to individual member memories is to overlook, or undervalue, the linking of those individual memories by shared experiences in the past, experiences that have established the extremely detailed and specific communication system that underlies routine performance' (Nelson and Winter, 1982). As a result, the mechanisms by which the firm grows are largely internal or endogenous to it. Although in the case of the business enterprise success or failure is ultimately measured by its performance in external markets, the growth of the firm does not consist of a unilinear process of adaptation to external pressures; rather, certain options are made facilitated, and others made more difficult, by its particular history (Penrose, 1959).

An important difference, then, between the evolutionary and contractarian approaches lies in their treatment of information and its implications for effective contracting. The evolutionary model stresses the limits to contractability: its 'emphasis on learning and the tacit, idiosyncratic and context dependent nature of knowledge lead to the conclusion that not all activities within the firm are contractible' (Hodgson, 1997; Foss, 1993: 135-136). In place of contractual efficiency and a market-like process of equilibrium, there is imperfect information and calculation, routinised behaviour, trial-and-error learning and slow correction by environmental feedback, leading to a process of growth which is both dynamic and uneven.

However, this does not mean that issues of contract are irrelevant within a competence-based model. There may be substantial scope for synthesis, or at least dialogue between the different approaches. The central issue here is that of contract incompleteness. Agency theory accepts that certain contracts may be incomplete, in the sense that the parties may be unable to specify expressly their future rights and obligations in all states of the world (Grossman and Hart, 1986: 691). This is particularly likely to be the case where the parties make relation-specific investments which cannot be redeployed, except at a certain cost, to other uses. The concept of asset-specificity, although used in an essentially static setting by transaction-cost theory, is analogous to the more dynamic notion of competencies whose value is reduced outside organisational context of the firm. Both transaction-cost theory and evolutionary theory can be seen as offering support for the view that agents involved in the productive process make long-term investments in the firm which cannot be protected by express agreements, but which depend on tacit or implicit understandings, or *implicit contracts*.

Implicit contracts may be thought of as understandings about co-operation, which, because of uncertainty about the future and the costs of making such understandings explicit, are too costly to formalise (Cornell and Shapiro, 1987: 5). As such, they are under-protected by comparison to those expectations which are the subject of recognised legal rights. As we saw, the principal claim of the contractarian model of the corporation is that groups such as employees are fully protected by the express terms of the contracts they agree with the firm, leaving the shareholders with the right to the residual. However, if the express contracts of employees, suppliers and others leave unprotected an element of residual risk, then the central argument for the position of shareholders as residual claimants fails to hold. Where employees, suppliers and others make firm-specific investments whose value outside the organisation may be minimal, they 'have as much claim to being owners of the corporation as do shareholders, and perhaps more so' (Blair, 1995: 239). By allocating residual rights only to shareholders, company law would be providing inadequate incentives for long-term investments in human and productive assets by the other

stakeholder groups: 'if the governance structure of the firm allows, or indeed requires, all such incomplete terms to be resolved in favour of the shareholders, we will be reluctant to make such contracts, or indeed to do business with the firm at all. It follows that [shareholder-owned firms] will be at a competitive disadvantage in areas where such implicit contracts are important' (Kay and Silberston, 1995: 90).

Shleifer and Summers (1988: 33) have argued that gains may be made from a hostile takeover through the 'breach' of implicit contracts between the firm and its long-term stakeholders, in the aftermath of a change of management. Hostile bids are frequently the catalyst for redundancies, cuts in wages, cuts in the prices paid to suppliers and increases in those charged to customers; these generate savings which go towards meeting the combined gains of the shareholders of the companies concerned. The 'contracts' which are supposedly 'broken' here are not contracts in any legal sense; the expectations are too inchoate to be given contractual protection. This does not mean, however, that these expectations have no economic value.

The central issue is why it should be in the interests of a new management to undertake changes which might harm its reputation and, if the 'stakeholder' hypothesis is correct, undermine the long-term profitability of the firm. The relative certainty of short-term gains, when set against the risks of maintaining longer-term investments, may answer this point. Mismatches between the share price of companies with relational investments and their true long-term value are also possible, at least if absolute belief in the efficient capital market hypothesis is suspended (Singh, 1995). An implication of the evolutionary model is that the share price of companies might not place an accurate valuation on 'unconventional' assets of firms, including its reputation for fair dealing with employees and with third parties. Winter (1993: 55) has suggested that this factor may have operated in conjunction with high real interest rates in the 1980s to encourage a strategy of disinvestment following takeovers: by lowering the current value of future returns on investments and enhancing uncertainty in the economy, high real interest rates made it attractive for firms to 'cash

out' reputational assets through the medium of corporate restructurings, and hostile takeovers provided the means to do this.

More generally, the notion that managers take decisions which add value to the share price of the company in the short term at the expense of possible longer-term gains is plausible in the context of a hostile takeover bid, when managers are under extreme pressure to demonstrate good financial performance to the capital market. The strategy of 'breaching' implicit contracts in order to realise immediate cash-flow is one which might appear attractive both to an incumbent management team attempting to stave off an unwelcome bid, and to a successful raider seeking to justify the takeover to its own shareholders and to the wider market. In principle, cuts in long-term investments will be penalised by the market if it concludes that the effect is to reduce the net present value of the business; but it would be rational for managers to impose the heaviest cuts on investments whose value could not easily be measured in the short-term.

High real interest rates may, as Winter suggests, help to explain why takeover activity was so intense in the period of the mid to late 1980s. Another potentially important source of explanation which might account for the incidence of takeovers may lie in the incentives provided by different systems of corporate law and governance. Systems which actively promote a market for corporate control and which stress the goal of maximising shareholder wealth may induce managers to focus on short term considerations, in particular the need to stave off unwelcome bids by raising the company's share price by whatever means available, including redundancies (Stein, 1988: 61). The effects of the market for corporate control would then be felt more widely in the system as a whole, as its advocates suggest, but this time the effects would be destructive of wealth.

The implications of the stakeholder approach for public policy are not as clear as those of the contract model. In general, there is a greater emphasis on 'voice' or internal monitoring processes, rather than 'exit' to the market. Voice, in this context, means the 'establishment of

information and communication channels' between the different elements in the production process, and 'high levels of commitment' on the part of the contracting parties (Foss, 1993: 138). Here a number of options arise, including more formal mechanisms of employee representation and a more active role for 'relational investments' by institutional shareholders. However, further work needs to be done on the comparative costs of internal and external monitoring before a clear picture can be said to emerge. Nor is it evident that 'implicit contracts' should be given unqualified legal protection. Jensen (1993: 849) has maintained that 'not all contracts, whether explicit or implicit can (or even should) be fulfilled. Implicit contracts, in addition to avoiding the costs incurred in the writing process, provide opportunity to revise the obligation if circumstances change; presumably, this is a major reason for their existence.' Certain aspects of Jensen's analysis could be reconciled with an evolutionary perspective, in particular the emphasis on takeovers providing a vehicle for organisational learning and for the replication of successful routines across firm boundaries.

In short, economic theory offers a number of perspectives on the efficiency of hostile takeovers. Underlying these approaches are contrasting economic conceptions of the corporation. The evolutionary or competence-based model, while not incompatible with certain aspects of a contractual analysis, offers a wider perspective on organisational aspects of the firm through which value is created. In particular, it suggests both a more strategic and proactive role for the management of the corporation than that implied by the theories of management neutrality in the face of takeover bid, and a more effective institutionalisation of voice-related mechanisms. At the same time, it does not rule out the possibility that certain takeovers (including some arising from hostile bids) may stimulate organisational innovation. We now examine the degree to which these different economic conceptions find support in legal notions of corporate form.



## Takeover Regulation and the Legal Form of the Corporation

The law governing takeovers is drawn in part from general principles of company law (such as those defining the relationship between the directors of the company and its shareholders) and in part from more specific regulations governing the takeover process (in the UK, principally the Takeover Code, and in the US the federal Williams Act, related Securities and Exchange Commission regulations and a substantial body of legislation at state level).<sup>11</sup> In this context, it is difficult to find support within company law for the widespread assumption of many corporate governance specialists and practitioners, particularly in the UK, that shareholders 'own' the business and that, as a consequence, it is necessarily the directors' duty to maximise shareholder value.<sup>12</sup> The ownership of shares does not entitle a shareholder to have access to the business assets of the corporation, nor does it enable him or her to exercise the rights of control which attach to the ownership of those assets.<sup>13</sup> Moreover, under the English common law, directors' fiduciary duties are to act *bona fide* in the interests of the *company* and not of the shareholders or any other corporate group. Section 309 of the Companies Act appears to go still further by stating that 'the matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members', i.e. the shareholders. Kay and Silberston suggest that given the nature of its legal structure, 'perhaps a large corporation is not owned by anybody at all, at least in the normal sense of ownership', meaning ownership as a right to possess and to exclude (Kay and Silberston, 1995: 87).

Yet it would be taking this argument too far to suggest that the shareholders have no ownership rights of any kind against the corporation. Company lawyers clearly recognise the existence of what Parkinson has called the 'legal model' in which the interests of the company are closely identified with the commercial interests of its members who are, in law, the *shareholders*. Although directors' duties are owed to the company, and may not normally be directly enforced

by the shareholders as a consequence of the rule in *Foss v. Harbottle*,<sup>14</sup> this does not mean that the directors must further the interests of the company *as a legal entity*:

The correct position is thus that the corporate entity is a vehicle for benefiting the interests of a specified group or groups. These interests the law has defined as the interests of the shareholders. The duty of management can accordingly be stated as a duty to promote the success of the business venture, *in order* to benefit the members (Parkinson, 1993: 77).

Section 309, which seems to indicate otherwise, is not as significant as it might appear to be. This is because it gives no standing to the employees, as a group, to enforce the obligations to which it refers, any more than the shareholders normally have such standing.<sup>15</sup> Moreover, although the language of section 309 appears to be mandatory, this impression too is misleading. Section 309 does not alter the fundamental nature of directors' fiduciary duties at common law, which is that they are subjectively defined: the directors must act in what *they think* are the company's best interests.<sup>16</sup> Except in an egregious case, directors are protected against litigation by the 'business judgement' rule, which effectively means that the courts will not review judgements made in good faith concerning business matters on which they have limited expertise.<sup>17</sup> Moreover, section 309 simply stipulates that the employees' interests are to be taken into account in the context of this broad discretion to balance conflicting interests; it does not stipulate that at any point employees' interests should take priority over those of other corporate constituencies. The limited significance of section 309 has been reaffirmed in the few cases in which it has been discussed since its first appearance in 1980 (see Parkinson, 1993: 82-87).

The loosely defined nature of the fiduciary obligation may, at the same time, provide a degree of protection for directors who see the company's long-term interests as closely bound up with those of its 'stakeholders'. Here, the business judgement rule and the various obstacles to litigation associated with the rule in *Foss v. Harbottle* limit

the opportunities for direct shareholder pressure. The notion of the shareholders' financial interests can also be stretched a certain way to incorporate their longer-term interest in the success of the company as an enterprise.<sup>18</sup> It is plausible to argue, then, that the fiduciary principle, as it has developed in English law, would allow the directors to recommend rejection of a hostile bid if they felt that the incumbent management was better equipped than the bidder to maximise the company's value.

However, in practice, the content of directors' duties during a takeover bid has been clarified in a way which is hostile to such an interpretation, by the provisions of the City Code on Takeovers and Mergers. The Code is not legally binding, but among the sanctions for non-observance of its provisions is the withdrawal of a license to deal on the London stock exchange and the withdrawal of the authorisation needed to take part in investment business. The City Panel on Takeovers and Mergers is responsible for drawing up the Code and administers it, in the sense of giving rulings as to its meaning and issuing orders and sanctions (Virgo, 1995). The fundamental principle of the Takeover Code is that 'all shareholders of the same class of an offeree company must be treated similarly by an offeror'.<sup>19</sup> In particular, two-tier bids which discriminate between classes of shareholders are effectively ruled out by the Code, which requires the bidder, once it has acquired 30 per cent. or more of the voting rights of the company, to make a 'mandatory offer' granting 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 preceding months.<sup>20</sup> Partial bids, involving an offer aimed at achieving control through purchasing less than the total share capital of the company, require the Panel's consent, which is only given in exceptional circumstances.<sup>21</sup> During the bid, 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'.<sup>22</sup> Other provisions of the Code concerning public announcements of offers, restrictions on acquisitions, public disclosure of dealings in shares and the terms on which offers for

shares must be made, serve to protect minority shareholders (Virgo, 1995).

The Code also imposes on target directors a series of specific obligations which can be thought of as clarifying their duty to act *bona fide* in the interests of the company, but in some respects extend this duty beyond the normal bounds of fiduciary obligation. The target directors must first of all obtain competent, independent financial advice on the merits of the offer,<sup>23</sup> which they must then circulate to the shareholders with their own recommendation.<sup>24</sup> 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.<sup>25</sup> While the point is not completely clear, the likely effect of this is to create a legal duty of care, owed by the directors to the individual *shareholders* to whom the information is issued (and not to the *company* as is the case with their general fiduciary duties).<sup>26</sup> This potentially places the directors of the target in the position of being required to give disinterested advice on the merits of the offer, rather than being able vigorously to defend the existing management against what they might see as an unwelcome bid.

The Code 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'<sup>27</sup>; moreover, the Code requires the bidder to state, 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'.<sup>28</sup> Taken together, these provisions might imply that both the bidder board and the target board are required to take into account the wider interests of the offeree company's stakeholders, in particular the employees, in the discharge of their respective fiduciary duties.

However, this provision needs to be seen in the light of other provisions of the Code and of general company law principles. The essence of the directors' fiduciary duties, as we have seen, is that they are subjectively and broadly defined, so as to give directors considerable discretion as to whether and how far to take into account the wider interests of stakeholders. Neither the Code, nor the general law of fiduciary obligation, provides any mechanism for determining how conflicts between the interests of these different groups should be dealt with, nor are the courts likely to see themselves as equipped to evaluate decisions taken by the board in good faith under the business judgement rule. By contrast, the disclosure requirements of the Code have the effect of imposing upon the target board a much more specific obligation owed to the shareholders alone, as the recipients of the financial information and advice which the Code requires the target directors to disseminate. At the end of the day, it is this legal obligation which is most likely to concentrate the directors' minds and on which they will receive the most detailed recommendations from their own advisers.<sup>29</sup> These specific disclosure requirements could be said to operate, in practice, against the more balanced consideration of shareholders', employees' and creditors' interests which is the aim stated in General Principle 9 of the Code.

If the Code tends to elevate shareholders' interests above those of other groups, it also hampers potential anti-takeover defences in various ways. In particular, once an offer is made or even 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'.<sup>30</sup> More generally, the 'proper purposes' doctrine prevents the board issuing shares for the purpose of forestalling a hostile takeover, even well in advance of any bid being made.<sup>31</sup> Other advance anti-takeover defences, such as the issue of non-voting stock or the issuing of new stock to friendly insiders, have been discouraged by a combination of Stock Exchange rules and institutional shareholder

pressure. Protection of pre-emption rights, or the rights of existing shareholders to be granted preference when new stock is issued, is recognised by legislation<sup>32</sup> and by the Rules<sup>33</sup> and Pre-emption Guidelines<sup>34</sup> issued by the Stock Exchange. The issue of non-voting stock is permissible under the Companies Acts, but is opposed in principle by representatives of institutional shareholders.<sup>35</sup>

In contrast to these restraints on defences, controls over 'dawn raids' and other surprise tactics by bidders are limited. A bidder can increase its holding to up to 3 per cent. of the target's stock before being required, within two days, to notify the target board and the Stock Exchange of its acquisition,<sup>36</sup> and it can increase its holding to up to 15 per cent. of the target's stock before being required, the next day, to give notification.<sup>37</sup>

The Takeover Code, taken in conjunction with related aspects of company law, can be seen to provide strong protection for the interests of the target shareholders; that, after all, has been its main purpose (Johnstone, 1980). An important effect of this protection, however, is to encourage hostile takeover bids by placing limits on the defensive options available to the target management. An incumbent management is not required to be completely passive, and is permitted to put a case in its own defence, but opportunities for defence only arise in the context of an overriding responsibility to see that the shareholders' interests are safeguarded. The effect is not far removed from that of an auction rule which requires the incumbent management to extract the highest possible price for the target shareholders, if necessary by making it possible for rival offers to be made. The entry of second bidders is facilitated by the bid timetable imposed by the Code and by the effective ban on two-tier and partial bids which might otherwise be used to strong-arm the target shareholders into accepting the terms of the first bid.

These regulatory features might deter initial bids, by increasing the risk that either the target shareholders (Grossman and Hart, 1980: 42) or any second bidder (Easterbrook and Fischel, 1991) will free ride on the

efforts of the initial bidder. However, the possibility of free-riding by the shareholders is alleviated somewhat by the right of the bidder compulsorily to purchase the last 10 per cent. of shares in the event of taking control.<sup>38</sup> Other factors which serve to reduce the risk of an initial bid failing due to free-rider effects are the concentration of voting shares in most UK publicly-quoted companies in the hands of a relatively small number of institutional shareholders (whose relatively large individual stakes makes it harder for them to free-ride) and the right of an initial bidder to raise its offer price during the bid period (thereby enabling it to over-bid a second bidder) (Roell, 1986). While there may, then, be a certain screening-out of partial bids which, given their oppressive nature, may in any case not be efficiency-enhancing, (Yarrow, 1985), the effect of the Code is to reduce the autonomy enjoyed by the management of the target company in relation to its shareholders and thereby to limit the defensive options it has available to it.

As a result, the regulatory framework would seem to provide ample opportunities for hostile bids to be mounted successfully against UK publicly-quoted companies. In the takeover wave of the late 1980s, virtually all hostile bids involving more than one bidder resulted in a change of control, and cash bids nearly always succeeded unless the target found a white knight (Jenkinson and Mayer, 1994). Hostile bids continue to account for a substantial proportion of all mergers and acquisitions of UK public companies, and after the lull of the early 1990s when the recession led to a steep fall in merger activity, the incidence of hostile takeovers has begun to rise again. Hostile bids also continue to have a relatively high success rate. As the Table shows, over half of contested bids for UK public companies in the period 1991-1996 resulted in a takeover, and hostile bids accounted for nearly one fifth of all bids made.

The possibilities for effective takeover defence are at present stronger in the USA than in Britain, and the status of any auction rule is much more contentious. The framework for tender offers derives from the Williams Act, a 1968 statute amending the Securities and Exchange

Act 1934, which is a less far-reaching measure than the UK Takeover Code.<sup>39</sup> Although it sets time limits on tender offers and requires bidders with 5 per cent. of a company's stock to disclose their holdings and to give an indication of their business plan for the company, it does not explicitly rule out two-tier or partial bids. It regulates fraudulent activity, broadly defined, but does not place target directors under a clear-cut duty of care to provide independent financial information to shareholders in the way that the Code does. At state level, courts have also accepted that, under the business judgement rule, target directors can take steps to resist a hostile takeover where they act in good faith and with 'reasonable grounds for believing that a danger to corporate policy and effectiveness existed'; specifically, they can take into account the 'inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of the securities being offered in exchange'.<sup>40</sup> The Delaware courts have nevertheless vacillated between an auction rule which would require the board to take steps to maximise shareholder returns in the event of a proposed change of control,<sup>41</sup> and the 'just-say-no' defence under which the target board would be 'obliged to charter a course for the corporation which is in its best interests without regard to a fixed investment horizon' without being 'under any per se duty to maximise shareholder value in the short term, even in the context of a takeover'.<sup>42</sup>

US corporate law has permitted the growth of a battery of anti-takeover defences of a type which are virtually never adopted in publicly-quoted companies in Britain (Lipton and Panner, 1993). *Shark repellents* structure the composition of the board so as to make it difficult for an outsider to gain control. For example, company bylaws (the equivalent of articles of association) may stipulate that directors are elected for 3-year terms, with only part of the board coming up for renewal each year. It is also common for bylaws to prohibit *greenmail* (a raider forcing the target board to buy back its shares at a premium), to prevent shareholders from voting by proxy, to lengthen the gaps between



general meetings, and to require supermajority decisions to change these and other rules. *Poison pills* include various devices whereby insider shareholders acquire rights which are triggered when a hostile takeover bidder makes its entry, such as the *flip-in* (where if the raider increases its shareholding above a certain level the target board declares a high dividend for existing shareholders, or existing shareholders are given the right to buy additional stock at below the market price) and the *flip-over* (shareholders get the right to buy stock of the new parent at a discount).

In addition, most states have enacted anti-takeover statutes which enable companies to adopt internal rules aimed at fending off hostile bids. The first wave of such statutes was ruled unconstitutional in *Edgar v. MITE Corp.*<sup>43</sup> on the grounds that they were preempted by the Williams Act. In this case, an Illinois statute which extended the bid timetable beyond that set by the Williams Act and gave state-level competition authorities the right to nullify offers, was struck down. However, a second generation of 'share control' statutes (providing the incumbent shareholders with the power to decide on whether a raider with a controlling stake should retain the voting rights of its shares) was upheld in *CTS Corp. v. Dynamics Corp.*<sup>44</sup> at around the same time as the Supreme Court gave a restrictive ruling to the Williams Act, deciding that it did not bar defensive actions such as 'crown jewel' options or sales.<sup>45</sup> This simultaneously limited the scope of federal regulation and opened the way for further pro-defensive laws at state level. A 'third generation' of state laws followed, which, broadly speaking, validated various poison pill defences and introduced 'constituency' or stakeholder provisions into the definition of directors' fiduciary duties.<sup>46</sup>

These 'stakeholder statutes' vary in strength. Certain of them include provisions for *profit disgorgement*, whereby the state imposes a high tax on any short-term profits by raiders acquiring shares in connection with a bid, for example as a result of greenmail. Modifications to directors' duties include provisions to the effect that fiduciary duties are owed solely to the corporation and that no party, not even the

shareholders, can enforce them directly; that directors may consider the long-term interests of the corporation; and that the directors need not regard any one constituency's interest as dominant. The stakeholder statutes, together with the adoption of poison pills by a majority of large public corporations, are credited with having helped to bring the takeover wave of the late 1980s to an end.<sup>47</sup> More generally, it is plausible to argue that US corporate law has begun a paradigm shift, as part of which shareholder interests will no longer be accorded their traditional priority (Johnson and Millom, 1993), in contrast to the continuing emphasis on in Britain on maximising shareholder value to the exclusion of other interests.

There is an even stronger contrast with the mainland European systems. Hostile takeovers in Germany and France remain virtually unknown, in large part thanks to the system of corporate law and governance in those countries. It has been suggested that 'we do not need to speculate about different corporate cultures here to explain why [the hostile takeover] is not used in corporate Germany... There are quite a few more tangible and concrete arguments which explain this pattern as a result of specific structural features of German company law, as well as of the conditions of corporate finance and other peculiarities' (Baums, 1993: 155). These include the limited number of publicly quoted companies; in most European countries there is only a very small number of potential targets, compared to the US and UK. In Germany it has been estimated that of the fewer than 500 publicly quoted companies (compared to over 2000 in Britain<sup>48</sup>), only 30 are the subject of active share trading (Hart, 1992). More specifically, the German two-tier board structure under which listed companies operate means that control cannot easily be established against an incumbent management, even if significant shareholdings change hands. In Germany, the shareholder representatives on the supervisory board can only be removed before the end of their 5-year term by a 75 per cent. vote, and the management board members can only be removed by a vote of the supervisory board for good cause within their term of office. The principle of one share, one vote has been diluted in various ways. It is lawful for articles of association to place limits on voting, so that no

shareholder can have more than 5 per cent. of the company's voting rights, and to give the board a discretion not to register shares (such as those newly purchased by a corporate raider) (Franks and Mayer, 1990: 191; Kester, 1992: 24; Rydquist, 1992: 45). As in France, cross-ownership of shares by companies is widespread, and, in contrast to the position under the UK Takeover Code, cross-ownership between companies of up to 25 per cent. may be authorised by the boards of two companies without one of them mounting a takeover for the other.<sup>49</sup>

As in the case of economic theory, different conceptions of the corporation underlie these contrasting approaches to legal regulation. The Anglo-American system of company law incorporates many features of the contract model, not just in its emphasis on the protection of the interests of the shareholders as residual claimants, but more generally in its preference for low-cost exit over voice. There is little place for the notion of the corporation as a productive entity, separate from the contract and property rights of its members, employees and creditors; hence the tendency of the directors' fiduciary duty to collapse into an obligation to maximise shareholder value. The civil law systems not only restrict the option of shareholder exit by limiting the scope of the market for corporate control; they also recognise (albeit in terms which are the subject of much legal debate) the existence of a 'corporate interest' which finds concrete expression in the idea that 'duties are shifted from the profit interest of the shareholders to the public interest in profitability of the enterprise' (Teubner, 1994: 50; Alcouffe and Alcouffe, 1997).

### **The Economic Effects of Takeover Regulation**

We now consider how far the different economic theories are supported by empirical research on the effects of takeover regulation. At the level of broad inter-country comparisons, it is difficult to disentangle the impact of corporate governance systems from other economic factors. It has not been possible to establish, for example, a clear causal link between the high rate of hostile takeovers in the UK and the US and the comparatively low level of corporate investment in those countries

since the early 1980s, although it is striking that investment in research and development fell sharply in the UK in the late 1980s at the peak of the then takeover wave (Singh, 1995). Studies have tended to focus instead on the effects of hostile takeovers on shareholder wealth and corporate performance in the UK and US, and the impact there on corporate performance of amendments to the takeover rules and of internal corporate governance changes aimed at deflecting bids.

The most often-cited evidence for the efficiency-enhancing effects of hostile takeovers consists of findings to the effect that the premia paid to target shareholders in the US in the 1970s and 1980s ranged from 15-50 per cent. of the pre-bid price, with average returns in the 30-40 per cent. range. This marked an increase on the 1960s, when premia were on average 19 per cent, (Jensen and Ruback, 1983; Jarrell and Poulson, 1987: 127). Gains to the shareholders of acquirers in the 1980s were less substantial but still significant at around 1-2 per cent. of the pre-bid price, although this marked a decline from returns of 5 per cent. in the 1960s and over 2 per cent. in the 1970s (Jarrell, Brickley and Netter, 1988: 88). In addition to gains first to target shareholders, and, second, to bidder shareholders, it is suggested, thirdly, that the general efficiency improvements induced by the threat of takeover would generate gains to companies which never became either targets or bidders. It is on this threefold basis - but with evidence only concerning the first two claims - that it has been asserted that 'tender offers and the threat of tender offers in all likelihood add tens of billions of dollars to the value of America's capital stock each year' (Cohen, 1990: 114).

This positive impression of takeovers was reinforced by research which demonstrated share price falls in companies which adopted defensive measures and related corporate governance changes. Poison pill defences, supermajority amendments and dual-class voting rules were found to induce small but statistically significant share-price declines.<sup>50</sup> Similarly, companies incorporated in states which adopted anti-takeover statutes saw a fall in their share price. For example, companies protected by the restrictions allowed by Pennsylvania's 1990 statute saw their shares fall relative to those which opted out of the new law

(Szewczyk and Tsetsekos, 1992: 3). Again, consistent with this, the overall effect of the Williams Act was to produce a rise in the bid premia that acquiring companies paid to target shareholders and a corresponding fall in the returns to their own shareholders; there was no evidence that the Act had led to any reduction in the overall number of hostile bids (Jarrell and Bradley, 1980: 371). Further evidence that shareholder-protection measures induce increases in bid premia comes from a study of the impact of French legislation under which tender offers for shares in public companies had to be made through a tightly regulated auction process, with extensive disclosure requirements. Bid premia rose from an average of 34 per cent to 73 per cent. after the law was introduced (Eckbo and Langohr, 1989: 363).

This evidence is consistent with a view that hostile bids are effective at raising target shareholder value, and that shareholder-protection measures place the shareholders of companies that receive bids in a particularly strong position. However, it says very little one way or the other about the wider proposition that hostile bids are efficiency-enhancing. Almost all the evidence on this is drawn from 'event studies' which attempt to correlate share price movements with events such as the announcement of a bid. If the share price after the bid shows a statistically significant movement up or down, it can be read as an assessment by the market of the impact of the event on the company's underlying value, including the effectiveness of its management. One difficulty with the event-study technique is that it may be hard to establish the correct date from which to measure changes in the share price (at what point should it be assumed that the market has factored in the likelihood of an impending bid?). More fundamentally, it need not be the case that a short-term change in the share price accurately reflects the future value of the company. While this would follow if the efficient capital market hypothesis were correct, there is evidence to suggest that share price movements have only a limited connection to managerial performance either prior to or subsequent to a takeover.

With respect to the pre-bid period, the contract model suggests that hostile bids are induced by a decline in a company's share price relative

to other firms in the same industry, which is a sign that its management is underperforming. However, recent studies for the 1980s takeover wave suggest that the selection of takeover targets is not well correlated with levels of managerial performance (Cosh, Hughes, Lee and Singh, 1989: 73; Cosh, Hughes and Singh, 1990). Targets do not, on average, underperform relative to their industrial averages; nor, contrary to the idea that the market for corporate control serves to discipline ineffective management, is there any clear link between the size of the premium paid by the bidder to obtain control, and subsequent changes to the management structure of the company (Martin and McConnell, 1991: 671; Franks and Mayer, 1996: 163).

Evidence concerning post-bid performance also casts doubt on the disciplinary hypothesis. Several studies have identified long-term share-price declines following mergers, whether resulting from a hostile or an agreed bid (Langetieg, 1978: 365; Magenheim and Mueller, 1988: 171; although cf. Bradley and Jarrell, 1988: 253), and the most comprehensive study (Agrawal, Jaffe and Mandelker, 1992) has found that this negative effect intensified over time. The market consistently over-rated the prospects of companies making agreed bids, which subsequently lost value. Companies which made hostile takeovers did better, but nevertheless on average, they showed neither gains nor losses to a significant degree over the post-merger period. This finding broadly confirms earlier research which, rather than taking share price movement as the benchmark of company performance, was based on accounting data concerning companies' sales, assets and profits (Ravenscraft and Scherer, 1987: 147). This found that companies which were acquired by tender offers had slightly below industry-average cash flow and sales performance both before and after takeover, so that 'the hypothesis that takeovers improve performance is not supported' (Scherer, 1988: 76).

Identifying the precise source of the gains made at the time of a bid has proved generally problematic. To a certain extent, bid premia can be correlated to losses sustained by employees and suppliers in the aftermath of a bid, as the stakeholder model predicts, but the match is

very far from complete. Shleifer and Summers's study of the takeover of TWA by Carl Icahn suggests that around half the premium paid to TWA's shareholders can be accounted for by cuts in the wages and benefits of TWA's employees (Shleifer and Summers, 1988). However, over the whole range of mergers, no consistent pattern of employee losses can be identified; some analyses suggest that employee losses are lower in hostile bids than in either agreed takeovers or in targets which escape a bid (Lichtenberg and Siegel, 1990: 383; Rosett, 1990: 263).

Some preliminary conclusions may nevertheless be drawn. The empirical evidence suggests that the short-term increase in a company's share price which normally takes place in response to a hostile bid is not, in general, a reliable indicator of future improved performance. The present system of takeover regulation in the US and Britain, by defending the interests of target shareholders during a hostile bid, appears to raise bid premia, and thereby redistributes resources to the shareholders of the target company at the expense of the acquirer's shareholders. The takeover process as a whole is either neutral or has immediate negative effects on other stakeholder groups; its longer-term effects are more indeterminate. Despite the frequent assertion of a link between hostile bids and corporate performance, little proof is forthcoming. In the US, a link between defensive corporate governance changes and short-term share-price movements is well established. However, this could be compatible with rent-seeking by *shareholders*, who form an interest group which wishes to retain the right to decide control if an outside bid is made. This impression is confirmed by indications that UK managers are dissuaded from implementing defensive measures by concerted institutional pressure.

## **Conclusion**

Anglo-American systems of company law, while stopping short of according shareholders ownership rights over corporations, nevertheless vest significant property rights in the shareholders as residual claimants, in particular the right to determine control in response to a takeover bid. In the context of a hostile takeover, the

directors' open-ended duty to act in good faith in the interests of the company is transformed into a much more specific obligation to furnish information and advice which will enable the shareholders to maximise the value of their investment. In the United States, stakeholder statutes and the adoption of poison pills by a majority of large corporations have had a dampening effect on the market for corporate control; in Britain, by contrast, advance preparations against takeover bids are rarely undertaken by publicly quoted companies, and hostile takeovers remain an active force for economic restructuring.

The empowerment of shareholders through the market for corporate control is said to promote economic efficiency by disciplining corporate management and reallocating resources to more productive uses. However, on close inspection this argument proves difficult to sustain. On the present state of evidence, neither the selection of targets for takeover nor the post-takeover performance of companies subjected to hostile bids clearly bears out the disciplinary hypothesis. In other respects, too, the predominant forms of takeover regulation in common law systems are open to question. Certain versions of the contract model recognise that auction rules, which require target boards to mediate between and possibly to encourage competing bids, may simply shift wealth around, at no overall gain in terms of welfare. The competence-based model of the firm also suggests that takeovers may be destructive of wealth, by encouraging corporate managers to liquidate the firm's long-term productive assets in order to meet more immediate financial targets.

Economic analysis therefore provides much more limited support for a shareholder-orientated model of company law than is often supposed. We still understand little of the processes by which changes in the ownership-structure of corporations may induce organisational change and innovation. Nor do we know enough about the effects of the market for corporate control on firms which do not experience a change of ownership. To make progress in this area, research needs to focus on the mechanisms by which productive value within organisations is fostered over the longer term. Until that is done, it will be difficult to



make a more complete assessment of the regulatory framework for takeovers. Nevertheless, our analysis in this paper has important normative implications for company law. In particular, it shows that there is no guarantee of compability between a company law system aimed principally at the maximisation of shareholder value, and society's interest in maintaining a productive corporate sector.

## Notes

1. A hostile bid is defined for this purpose as an offer for a controlling shareholding which is not welcomed by the incumbent management, whether or not the management later recommends the acceptance of that bid or another one. See further our discussion, below.
2. Clearly, as with the term 'contract', these terms are not being used according to their legal meaning. The economic meaning of the 'principal-agent' relationship encompasses not just commercial agency but also the employment relationship, for example (Stiglitz, 1990: 241).
3. It is being assumed here that because the agent, like any other economic actor, is motivated by self-interest, he or she will have an incentive not to act in the principal's interests where they conflict with his or her own (Fama, 1980: 288).
4. The theory that monitoring is most effectively undertaken by a 'residual claimant' whose income is linked to the overall profitability of the firm is found in Alchian and Demsetz, 1972.
5. A non-exhaustive list of principal works here includes Bebchuk, 1982, 1985, 1988; Gilson, 1982; Coffee, 1984; Schwartz, 1988.
6. See for example, Bebchuk, 1985: 1696: defensive tactics by incumbent managements are 'very costly both to target shareholders and to society'.
7. To the extent that employees' pay is linked to profits - as it would be, in the case of profit-related pay - this assumption is partially undermined. However, it is important to note that the use of profit-related pay schemes in the United Kingdom has not, on the whole, been used by employers to vary pay

*downwards*; in other words, a fixed element of pay is usually protected against fluctuations in the firm's profitability. The use of profit-related pay appears to be linked very largely to certain fiscal benefits. See generally McLean, 1994.

8. Easterbrook and Fischel, 1991: 67-68, is to precisely the same effect.
9. On the analogy between the firm and the market, see in particular Jensen and Meckling, 1976.
10. This line of thought originates with the work of Frank Knight, in particular Knight, 1921.
11. Aspects of labour law, in particular those concerning the job security rights of employees and the rights of employee representatives to information, consultation and participation in decision-making, are also relevant, as is taxation; for reasons of space, we do not consider these issues in the present paper. Nor are we concerned with the implications of mergers for competition in product markets, which are the concern of competition policy.
12. See Wright, 1995: 168: 'The shareholders are the legal owners of the company'.
13. See Green, 1995: 149, where he suggests that ownership of the enterprise rests with 'the equity shareholders but only as an indivisible collective group'. However, even the shareholders as a group cannot get access to the business's assets except in the sense that they could vote to have the company wound up and the assets sold; but this would mean that the business had ceased to be a going concern. See generally for discussion of this point, Kay and Silberston, 1995; Ireland, 1996.
14. (1843) 2 Hare 461.

15. Companies Act 1985, s.309(2).
16. See *Greenhalgh v. Arderne Cinemas Ltd.* [1951] Ch. 286, 291.
17. See *Prudential Assurance Co. Ltd. v. Newman Industries Ltd.* (No. 2) [1982] Ch. 204.
18. *Gaiman v. National Association for Mental Health* [1971] Ch. 317, 330.
19. City Code on Mergers and Takeovers, General Principle 1.
20. *Ibid.*, rule 9. See also Companies Act 1985, s. 430A providing a statutory right to sell where the bidder and its associates control 90 per cent. in value of the relevant shares; s. 428 grants the bidder a right of compulsory purchase of the last 10 per cent. of shares.
21. City Code, rule 36; see Virgo, *op.cit.*, at pp. 316-317. On partial bids, see Ramsay, 1992: 369.
22. City Code, rule 20.1.
23. *Ibid.*, rule 3.1.
24. *Ibid.*, rule 25.1.
25. *Ibid.*, rule 19.2
26. Notwithstanding *Caparo Industries plc v. Dickman* [1990] 2 AC 605, it is possible that shareholders in receipt of the directors' statement could establish a duty of care in tort. See generally Markesinis and Deakin 1994: 90-92; Virgo, 1995: 322. In addition, there is some authority to the effect that directors giving misleading advice on the sale of shares may be liable to the shareholders concerned for breach of statutory

duty: *Gething v. Kilner* [1972] 1 All ER 1166; Virgo, 1995: 323.

27. General Principle 9.
28. Rule 24.1.
29. Some case-law on fiduciary duties also suggests that, during a *contested* takeover, *only* the interests of the shareholders can be taken into account: *Heron International Ltd. v. Grade* [1983] BCLC 244.
30. City Code, Rule 21.
31. See *Howard Smith Ltd. v. Ampol Petroleum Ltd.* [1974] AC 821, discussed by Parkinson, 1993: 143.
32. Companies Act 1985, ss. 85-89.
33. Admission of Securities to Listing, s. 5, ch. 2, para. 37.1 provides that pre-emption rights should only be disapplied for the period between annual general meetings, rather than for up to 5 years as permitted by the Companies Act 1985, ss. 89-95.
34. The Guidelines were issued on 21 October 1987 by the International Stock Exchange's Pre-emption Group, which consists of members of the ISE and officers of the principal representatives of institutional shareholders, namely the Association of British Insurers and the National Association of Pension Funds. Under Guideline 1.2, the Investment Committees of the ABI and NAPF are to advise their members, under normal circumstances, to approve resolutions for annual disapplication of pre-emption rights, as long as the non pre-emptive issue does not exceed 5 per cent. of the issued ordinary share capital as shown in the latest published accounts of the company.

35. Guidelines published by the Institutional Shareholders Committee in December 1991, *The Responsibilities of Institutional Shareholders in the UK*, state that 'institutional shareholders have for many years been opposed to the creation of equity shares which do not carry full voting rights and have sought the enfranchisement of existing restricted voting or non-voting shares' (para. 3). The Institutional Shareholders' Committee consists of the ABI and NAPF together with the Association of Investment Trust Companies, the British Merchant Banking and Securities Houses Association and the Unit Trust Association.
36. Companies Act 1985, s.199.
37. Rules Governing Substantial Acquisitions of Shares, rule 3.
38. Companies Act 1985, ss.428-430A; see Yarrow, 1985: 3.
39. 15 USC § 78 m-n.
40. *Unocal v. Mesa Petroleum* 493 A.2d 946, 955 (1985); although see also Lipton and Panner, 1993: 128, for discussion of circumstances in which the 'other constituencies' aspect of *Unocal* will not apply.
41. *Revlon Inc. v. McAndrews & Forbes Holdings Inc.* 506 A.2d 173 (1986); *Paramount Communications Inc. v. QVC Network Inc.* 637 A.2d 34 (1994).
42. *Paramount Communications Inc. v. Time Inc.* 571 A.2d 1140 (1989). On Delaware's 'zig-zags', see Roe, 1993: 321, and Blair, 1995: 220-222.
43. 457 US 624 (1985).
44. 481 US 69 (1987).

45. *Schreiber v. Burlington Northern Inc.* 475 US 1 (1985).
46. These have generated a large literature which includes Roe, 1993; Karmel, 1993: 1156; Johnson and Millon, 1993: 1177; Orts, 1992: 16; Daniels, 1993: 315.
47. See Roe, 1993 and Jensen, 1993; Useem, 1996: 27-28, reports that over two-thirds of large US public corporations have adopted poison pills, and that acquisitions of public corporations, which had been running at over 400 per annum in the late 1980s, fell to half that figure in the mid-1990s. We are grateful to Teresa Ghilarducci for this reference.
48. At the end of December 1994, there were 2,070 publicly quoted UK and Irish companies listed on the London Stock Exchange, and a further 207 on the Unlisted Securities Market; there were 423 German companies listed on the Frankfurt stock exchange. *London Stock Exchange Factbook 1995*: 38, 48.
49. The Frankfurt stock exchange has recently adopted a Takeover Code modelled on that of the UK, but the existence of a Takeover Code aimed at regulating tender offers is unlikely, of itself, to lead to a greater incidence of hostile takeover activity in Germany.
50. The evidence is summarised by Jarrell, Brickley and Netter, 1988 and, more recently, by Hawley and Williams, 1996: 35-48.

## **TABLES**



# UK Public Takeover Bids, 1991-1996

UK Public Bids, 1991-1996		Contested Bids:			Agreed Bids:			% of Total Bids		All Bids Totals
		Contested	Late Agreement	Total Contested	Agreed	White Knight	Total Agreed	Contested	Agreed	
1991:	Completed	13	0	13	71	0	71			84
	Failed	14	0	14	10	1	11			25
Success Rate:				48.19%			80.69%			79%
Total:		27	0	27	81	1	82	24.8%	75.2%	109
1992:	Completed	6	1	7	50	2	52			59
	Failed	6	0	6	4	0	4			10
Success Rate:				33.6%			92.99%			86%
Total:		12	1	13	54	2	56	18.8%	81.2%	69
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%			90.9%			88%
Total:		9	2	11	61	0	61	15.3%	84.7%	72
1995:	Completed	6	4	10	75	2	77			87
	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
<b>1991-96 Totals:</b>										
Completed		41	12	53	379	6	385			438
Failed		41	1	42	34	2	36			78
Success Rate:				55.8%			91.4%			85%
Totals:		82	13	95	413	8	421	18.4%	81.6%	516

Source: Mergers and Acquisitions Monthly, Annual Reviews, January 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 1007. These bids have been counted as contested bids.

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