

**Defensive measures adopted by the board:  
Current European Trends**

by

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**Company Law Reform in OECD Countries  
A Comparative Outlook of Current Trends**

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## 1. Introduction: *ex ante* and *ex post* approaches

**I** - The regulation of defensive measures and the legislative definition of the proper role of the board during the course of a take-over lie at the heart of the relation between company law and securities law. It involves central themes on both fields of law, such as the relevant interests of the company, the duties and the liability of the directors, the role of the general meeting of shareholders, the shareholders' freedom to decide upon the merits of the offer and its relation with the market for corporate control.

The practical importance of the issue is out of the question, not only in Anglo-Saxon countries – that register a considerable take-over activity –, but also in European States, where – as a consequence of the globalisation process accelerated by the introduction of the Euro – hostile bids are becoming more and more frequent.

**II** - It is clear that anti-take-over strategies give way to two main legislative responses<sup>1</sup>: one perspective is to opt for a possible judicial review to be made after a defensive action is put into place; the other view prefers to prohibit *ex ante* a number of possible frustration acts to be decided by the board. The first approach is mainly found in the USA, while the second is revealed in the United Kingdom. On the one hand, the American legal system has shown preference for an *ex-post* type of control, relying on directors' fiduciary duties, although seen at more demanding standards than the business judgement rule<sup>2</sup>. On the other hand, the British Take-over Code is based on the strict prohibition of frustrating action without the consent of shareholders.

The legislative preventive prescription of a limited range of action related to the board has influenced the European Community proposed directive in relation to take-overs<sup>3</sup> in its several versions – and has been at the centre of attentions in the examination of the text by the European Parliament for second reading<sup>4</sup>. The General Principles of the proposed EC text determine that the board should act in the interests of the company as a whole, and must not deny the shareholders the opportunity to decide on the merits of the bid<sup>5</sup>. Related to this principle, the revised proposed Directive impedes actions decided by the board to frustrate the bid not authorised by the general meeting of shareholders<sup>6</sup>.

The text of the proposed Directive has, nevertheless, a major restriction for it does not apply to defences adopted before the bid<sup>7</sup>. Therefore, it leaves aside many classical anti-take-over devices, such as the regulation of voting caps, supermajority requirements, poison pills, cross-shareholdings, golden parachutes, and others.

Nonetheless, the point is that, following the multiple versions of the proposed Directive, several European countries have imposed legislative limitations on the adoption of defensive measures by the board during take-overs<sup>8</sup>. Moreover, recent times have shown evolutions in the European

<sup>1</sup> WEIGMANN (1992), 612-613; WEIGMANN (1993), 568-572.

<sup>2</sup> See, *inter alia*, FLEISHER JR., A./ SUSSMANN, A. R. (1997), § 9.01; FARRAR (1993), 359-381.

<sup>3</sup> WYMEERSCH (1992), 127.

<sup>4</sup> The Council of Ministers of the European Union has, on the 19th June 2000, adopted a Common Position regarding a third version of the proposed directive on takeovers, which has already been examined by the European Parliament for second reading. The Proposed text will now enter into the reconciliation process. The text of the Common Position is available at OJ C 23, 24.1.2001 and at [http://europa.eu.int/eur-lex/en/dat/2001/c\\_023/c\\_02320010124en00010014.pdf](http://europa.eu.int/eur-lex/en/dat/2001/c_023/c_02320010124en00010014.pdf)

For a brief description, see COB (1999); [http://europa.eu.int/internal\\_market/en/company/company/news/takeover2.htm](http://europa.eu.int/internal_market/en/company/company/news/takeover2.htm). Unofficial reports on the discussion on the European Parliament, that took the discussion of defensive measures as one of the main points, can be found at: [www.tob-eur-opa.com](http://www.tob-eur-opa.com).

<sup>5</sup> Article 3. 1. (c).

<sup>6</sup> The rule regarding defensive measures adopted by the board – Article 8 a) in previous versions - is presently located at article 9.

<sup>7</sup> HOPT (1992a) [claiming the Directive has more or less *avoided the problem*], 186; HOPT (1992b) 41; WYMEERSCH (1997), p.4; WOUTERS (1993), p. 291-292. It should be noticed, nevertheless, that the Common Position determines that Member States may allow the increase of share capital during the period of acceptance of the bid if authorised by the general meeting of shareholders in the 18 months previous to the bid, provided that pre-emption rights of shareholders are not excluded (Article 9.2).

<sup>8</sup> Regarding those countries who have not implemented such restrictions, the Federation of European Stock Exchanges recommended the Exchange, the securities commission or other authorities to require the fullest possible public transparency of defensive actions by the offeree company, as they are price sensitive news (FESE *Take-over Principles 2000*, n. 9).

regulation of defensive measures, which confirms that the legal impact of defensive mechanisms is still largely a *developing area*<sup>9</sup>.

Although not every European country has direct legislation on take-over defences<sup>10</sup>, much of the developments occurred showed a convergence with the spirit of the Community text, even though being presently only a proposed directive. For example, in Italy the changes introduced by the 1998 *Testo Unico in Materia Finanziaria* had, as one of the main motivations, the will to adopt a text closer to the future directive on take-overs<sup>11</sup>. The same applies to the recent Austrian law on take-overs<sup>12</sup>.

**III** - This short comment addresses these recent legislative interventions, summarising a comparative analysis on the major trends and the underlying policy issues. The choice for a comparative exercise is due to the fact that, from the legislators' point of view, this issue requires a fine balance, on the one hand, between the use and the abuse of defensive tactics, and, on the other hand, between the interest of the offeror and the interest of the offeree company. Therefore, the analysis of different legislative solutions can shed some light on the optimal solution *de iure constituendo*.

Defensive measures have many types of sources: law (such is the case of golden shares adopted by state partially owned companies), by-laws of the company, shareholders agreements, and acts undertaken by the board. This paper deals only with the latter in a special context – it focus on measures adopted by the board during the course of take-overs for publicly held companies.

## **2. Rationale for the limitations of the board: a critical analysis**

**I** - First of all, it should be kept in mind what sort of reasons support the rule that limits the board of directors' range of action during a take-over. This is not a subject for unanimous analysis, for each argument raises a possible counterargument.

From one point of view, it is pointed out that defensive measures can function as an impediment for the market for corporate control in what regards directors' accountability. This argument is basically structured as follows: defensive measures raise the cost of take-overs, making them infrequent. Pressure on the directors' performance will consequently diminish – which undermines shareholders welfare in the long run. Under this reasoning, defensive measures would frustrate the disciplinary function that take-overs accomplish regarding to directors being, therefore, a cause of inefficiency in the markets<sup>13</sup>.

A complete assessment of this argument can only be done when gathered empirical evidence on the costs of take-overs and on the efficiency of defensive measures to deter tender offers<sup>14</sup>. However, recent empirical studies challenge the traditional disciplinary view of take-overs, claiming that take-over threats make manager's efforts decrease. The reasoning behind this view stems from the alleged fact that under a bid pressure the manager, because he knows he can be overruled, may have less incentive to invest effort in trying to learn the firm profit opportunities<sup>15</sup>. The risk of short termism is, therefore, significant<sup>16</sup>.

<sup>9</sup> HAZEN (1995), p.341; HOPT (1997), p. 391-392.

<sup>10</sup> Luxembourg (with no specific takeover law) and Finland remain with no direct legislative response on defensive measures. See SAVELA (1999), p. 256-257.

<sup>11</sup> About the EC proposal's influence on new Italian text, *inter alia*, see CHIAPPETTA (1998), p. 968-969; GATTI (2000), p. 606; MECATI (2000), p. 255; MOSCA (1999), p. 260-264; PICONE (1999), p. 122. The previous legal framework, approved by law n.° 149/92, was much stricter, impeding any amendment in the articles of association of the target company during the takeover (article 16). Significant changes in the assets and liabilities of the target company with no counter-advantages were then punished with criminal sanctions.

<sup>12</sup> For a comment on the proposed § 12, see DORALT/ NOWOTNY/ SCHAUER (1997), 257-258.

<sup>13</sup> CLARK (1986), p. 589.

<sup>14</sup> See *infra*, 3.

<sup>15</sup> HAAN/ RIYANTO, (1999).

<sup>16</sup> MUCCIARELLI (2000), p. 225.

It should be added that there are some corporate governance instruments that can promote defences aligned with the interests of shareholders such as managerial ownership<sup>17</sup> and compensation based on performance of the company.

Moreover, it should be underlined that there are cases of take-overs presented with purely speculative purposes – which shows the oversimplification revealed by judging that every defensive measure is harmful to the markets' efficiency<sup>18</sup>.

The same conclusion could be inferred from the OECD Principles on Corporate Governance, as it states that *anti-take-over devices should not be used to shield management from accountability* (I. E. 2.). Although it expresses the concern that widespread use of anti-take-over devices may be a serious impediment to the functioning of the market for corporate control, it implicitly admits that not all anti-take-over devices do harm accountability of directors.

The appreciation of this argument can only be completed with a look at the empirical evidence of the economic effects of defensive tactics, which will be dealt with above<sup>19</sup>.

**II** - Other authors defend that after the presentation of a bid there is a high danger that directors find themselves in a conflict of interests. In fact they might feel a tendency towards resisting hostile bids for the sake of keeping their board seats – position that would contrast with the interest from other constituencies, namely but not exclusively the shareholders<sup>20</sup>.

The imposed duty of neutrality would then be a way to reduce agency costs and to prevent too risky or too costly tactics and, thus, not only keeping the conflict of interests at a lower level, but also promoting the interest of the target shareholders<sup>21</sup>. This reasoning comes very much in line with the text of the Proposed Directive that clearly links the duties of the directors to act in the shareholders' interest to the duty to abstain from taking frustrating action<sup>22</sup>.

However, defences do not arise solely from the conflict between the personal interest of the director and the interests of the company. There might be other purposes behind take-over defences such as the protection of the company, its shareholders, or other stakeholders<sup>23</sup>. Directors can resist take-overs just as a way of bargaining for a better price<sup>24</sup>. Or they can implement an anti-take-over tactic because they feel that the bid presented will harm the shareholders' interests. The most remarkably is the case of the defences aimed at deterring the so-called bust-up take-overs or, in other words, take-overs targeted at dismantling the company in a later stage.

Under this reasoning, some regulatory texts prefer a different approach of the interest issue regarding defensive measures. This can be illustrated by the Portuguese 1999 Corporate Governance Code that recommends that measures adopted to prevent the success of take-over bids *“should respect the interests of the company and its shareholders”*. In addition, the Code states that *“measures considered contrary to these interests include defensive clauses intended to cause an automatic erosion in company assets in the event of transfer of control or change of composition in the board, detrimental to the free transferability of shares and the free assessment by shareholders of the performance of members of the board”*<sup>25</sup>. Therefore, this Corporate Governance Recommendations notices a distinction to be made between benign defensive measures and those

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<sup>17</sup> The text refers managerial ownership at an optimal level. Excessive managerial share ownership has proven to be detrimental to stock's prices. See McWILLIAMS (1990).

<sup>18</sup> In the same sense, GREGG JARELL states that *simply observing a litigious defense is an insufficient basis for claiming that target management is acting counter to its shareholders' best interests* which, in the author's findings, is consistent with the well-supported conclusion that *deliberately blocking all takeover attempts is very harmful to target shareholders* (JARELL (1985), p. 175).

<sup>19</sup> See *infra*, 3.

<sup>20</sup> CLARK (1986), p. 588; WEIGMANN (1992), p. 611; WEIGMANN (1993), p. 568; PICONE (1999), p.127; HUBER/ LÖBER (1999), p. 85; SCHUSTER/ ZSCHOCKE (1996), p. 57-58; MUCCIARELLI (2000), p. 224-225; GARCÍA DE ENTERRÍA (1999), p. 35; FERRARINI (2000), p.766-767.

<sup>21</sup> SCHUSTER/ ZSCHOCKE (1996), 155.

<sup>22</sup> See *supra*, 1, I. This connection is perhaps even clearer under Austrian Takeover Law (§ 12), as one can conclude from DORALT/ NOWOTNY/ SCHAUER (1997), p. 257.

<sup>23</sup> SAVELA (1999), p. 19-20.

<sup>24</sup> HADDOCK/ MACEY/ McCHESNEY (1987), 118-149.

<sup>25</sup> Recommendation n. 13. An English translation of the Recommendations is available as the Portuguese Securities Commission website: [www.cmvm.pt](http://www.cmvm.pt).

that harm the rights and expectations of shareholders and the market in general even if the criteria to distinguish one from another are not made explicit in the recommendations' wording.

**III** – The last main argument is maintained by authors who claim that take-over defences can affect the target shareholders' right to decide on the merits of the bid. Shareholders are the ultimate targets of take-over bids, so it should be up to them to decide whether a bid should have success or not<sup>26</sup>. From this point of view, the need for a general meeting's approval is an instrument to protect shareholders in detriment of the incumbent management.

However, the coercion issue also serves the opposite view. It is observed that target shareholders are usually under pressure to sell their shares in the take-over bid, even by a lower price than the real value of the shares, fearing a lower price in the future<sup>27</sup>. To mitigate this effect and to overcome the collective action problem, the incumbent directors can create an interest from other potential acquirers and form an auction boosting, therefore, the terms of the previous offer<sup>28</sup>. In the US, this argument gave cause to a famous decision by the Delaware Supreme Court (*Revlon v. McAndrews & Forbes Holdings*) according to which once a sale of the company becomes inevitable, defensive mechanisms must stop, and the role of the target board becomes that of a "fair auctioneer", in the search of maximising value for the shareholders<sup>29</sup>.

**IV** – Although these are general remarks, some justifications only apply for certain types of defences. Such is the case for defensive measures that, consisting of manipulative schemes, artificially affect market prices<sup>30</sup>.

**V** – To put into perspective this discussion, it should also be added that the role of the board during take-over bids is also important in the report made public to the shareholders. That report involves a critical examination of the terms of the offer and represents a decisive guidance to the shareholders on whether they should tender<sup>31</sup>.

It might be interesting to refer to a recent evolution of Portuguese law on this subject. The 1991 Securities Code used to impose a double report by the board of the target company - a preliminary one shortly after the first announcement of the bid and an extended one before the final documents of the offer. The requirement of a preliminary comment on the bid was abolished in 1999 mainly because it usually led to a premature judgement on the hostile bid. Thus, under the new Securities Code, the board report on the terms of the bid is made in relation to the project of its formal announcement<sup>32</sup>.

### 3. Empirical evidence

**I** – Economic analysis of company law plays a very relevant role in the critical assessment of the regulation of defensive measures. Under this context, multiple approaches and methods could be used in order to obtain some empirical evidence on the effects of defensive tactics.

Assuming that defensive measures deter take-over activity, the most ambitious exercise involves the determination of the economic effects of take-overs. The overall balance here is controversial. It

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<sup>26</sup> GARCÍA DE ENTERRÍA (1999), p. 172-173.

<sup>27</sup> BEBCHUK (1987), p. 911-949.

<sup>28</sup> WESTON/ CHUNG/ SIU (1998), p. 431; SHLEIFER/ VISHNY (1986); GARCÍA DE ENTERRÍA (1999), p. 33; FERRARINI (2000), p. 765.

<sup>29</sup> "Obtaining the highest price for the benefit of the stockholders should have been the central theme guiding director action": see *McAndrews Forbes Holdings, Inc. v. Revlon, Inc.*, Del. Ch., 501A.2d 1239 (1985); CARY/ EISENBERG (1995), p. 1242-1254 (1250); JENNINGS/ MARSH/ COFFEE (1992), p. 712; ROMANO (1992), p. 28-38.

<sup>30</sup> CLARK (1986), p. 578.

<sup>31</sup> Usually these reports include profit forecasts, which are sometimes considered as defensive mechanisms.

<sup>32</sup> See article 181, n. 1 Securities Code. An English version of this Code can be found at: [www.cmvm.pt](http://www.cmvm.pt).

is proved that share price performance declines after take-over acquisitions<sup>33</sup>, yet a substantial number of authors consider that take-overs lead to positive economic effects<sup>34</sup>.

**II** – A common way of calculating the effect of adopting take-over defences is to study their impact on prices. But the results, in this field, have basically proven to be inconclusive<sup>35</sup>.

As a matter of fact, conventional wisdom concludes that take-over defences can have one of two effects: they either provoke a decline of the prices, if they prevent the market for corporate control to function, impeding shareholders to sell their stocks; or lead to an increase of prices, if they force a competitive bidder to show up<sup>36</sup>.

Empirical evidence supports this conclusion. Indeed, studies reveal a negative impact on the value of the company for management entrenchment-effect is adverse to economic efficiency<sup>37</sup>. Other authors, however, retain that defensive manoeuvres cause a positive influence, although among them, even recognising an immediate decline in prices, state that managerial resistance can be value maximising in the long run<sup>38</sup>.

**III** – Another possible method to detect the economic effects resulting from defensive measures regards the measurement of take-over premium. Some authors argue that take-over *premia* are relatively high, which means that target shareholders can benefit from the acquisition. According to this view the limitation of take-over defences can be considered a way to protect shareholders and to increase take-over efficiency<sup>39</sup>.

Nevertheless, this cannot be considered as absolute, as the market experience shows clearly that there are also under priced offers. One example is to be found in the take-over presented in December 1999 for Portuguese's *Colep* shares that had a bid price under the market price, and this fact unsurprisingly led to its failure. Moreover, other studies demonstrate that bid *premia* can have less influence on the outcome of the bid than other factors, such as the method of payment or the ownership structure of the target company<sup>40</sup>.

**IV** – To reach a conclusion from the empirical evidence taken from defensive actions, it is also tempting to consider the costs involved therein. Studies indicate that, as a proportion of the bid value, the costs normally vary from 1.6 to 2 per cent of the amount of the bid<sup>41</sup>. Nevertheless, these results are hardly meaningful, for they do not reveal whether, from the shareholders' or the company's point of view, the defensive expenses were worthy or not.

**V** – Take-over defences can differ radically one from another, which suggests that the correct way to evaluate take-over mechanisms' effect comprises a separate analysis for each tactic.

In the one hand, evidence suggests that the success of defensive measures relies highly on the type of offer presented and on the sort of defensive tactic deployed. For instance white knight defences have caused positive results to deter hostile acquisitions<sup>42</sup>.

On the other hand, economic results widely differ in relation to the defensive measure put in practice. It has been shown that corporate restructuring<sup>43</sup>, green mail and stand still arrangements are normally detrimental, whereas defensive litigation by offerees usually results in higher premium

<sup>33</sup> AGRAWAL/ JAFFE/ MANDELKER (1992); LIPIN/ DEOGUN (2000), p. 29 a; FINANCIAL TIMES (2000); MOSCA (1999), p. 267. It should be noted that in some cases the decline in prices is caused by the concentration of share ownership that may result from the takeover bid.

<sup>34</sup> EASTERBROOK/ FISCHER (1991), p. 171-174, 193-196 (1993); ROMANO (1992), p. 4-11; REUL (1994), p. 151-215; WESTON/ CHUNG/ SIU (1997) p. 80-87, 124-145

<sup>35</sup> ALVES / OLIVEIRA (1999).

<sup>36</sup> SAVELA (1999), p. 18-19.

<sup>37</sup> JENSEN (1983).

<sup>38</sup> SHLEIFER/ VISHNY (1986).

<sup>39</sup> MARTINI (1999), 12.

<sup>40</sup> SUDARSANAM (1995a), p. 224-237.

<sup>41</sup> SUDARSANAM (1995b), 204-205.

<sup>42</sup> JENKINSON/ MAYER (1994) show good results from white knight defences, p.46-50.

<sup>43</sup> CHAKRABORTY/ ARNOTT (2000).

to target shareholders<sup>44</sup>. This is an important conclusion, for it suggests that *differential regulation should be adopted*, instead of a monolithic legislative answer for anti-take-over defences, regardless of their type or the economic effects they can lead to.

#### 4. The legal definition of the beginning of the sensitive period

I – Let’s now turn to analyse some of the features of European regulatory interventions on anti-take-over measures. In some States, the sensible period begins at the moment of the publication of the bid announcement. Such are the cases of Germany<sup>45</sup>, Switzerland<sup>46</sup>, and Spain<sup>47</sup>. This is an objective criterion, easily understood by the markets and applied by the courts.

In some cases, however, that system may prove to be fallible, as the board of the target company can have access to information regarding the imminent presentation of a bid and thus rapidly organise a defensive tactic. This has been notably the case of the 1988 *Société Générale de Belgique* affair that still constitutes a landmark in European take-over law, where the target board was informed about the bid before the formal communication and decided overnight to raise the capital in favour of an affiliate company<sup>48</sup>.

II - This type of risks are settled in the UK, where the City Code imposes restrictions on frustrating action from the moment a bona fide offer was communicated to the board of after the board has reasons to believe a bona fide offer is imminent<sup>49</sup>.

It is worth mentioning three legal systems that have undertaken recent reforms aimed at tackling this issue.

Firstly, the recent Austrian Take-over Law forbids take-over defences once the offeree company *becomes aware* of the offeror’s intention to make a bid<sup>50</sup>.

In Portugal, the 1991 Securities Code imposed a restriction in acts decided by the board from the moment the board has received the first notice of the bid<sup>51</sup>. This has been subject to a change under the 1999 Securities Code, which establishes that the passivity rule<sup>52</sup> starts from the moment where the offeree company knows about the decision to present a take-over bid. To help defining the precise moment regarding the knowledge of the bid, there is a *iuris tantum* presumption that the take-over is known from the moment of the board receives the preliminary notice of the bid<sup>53</sup>.

In Sweden, the 1988 version of the Recommendations Concerning Public Offers for the Acquisition of Shares stood against defensive tactics from the moment when negotiations have been entered into with the board or management of the target company concerning a take-over, or after an offer has been made. The formulation of this recommendation was changed in 1999 into a version that seems a refinement of the one found in the British City Code – the impediment now starts once the board or *senior* management has *good* reason to assume that a *serious* offer is imminent<sup>54</sup>. To determine what is a serious offer, the recommendation adds, “The potential bidder clearly must have the prerequisites to finance the offer”.

The two latter examples show a common tendency to recognise a right to implement defensive tactics if there is a mere *probability* of a presentation of the bid.

<sup>44</sup> JARREL (1985), 157-177; CLARK (1986), p. 591.

<sup>45</sup> Article 19 *Übernahmekodex*.

<sup>46</sup> Article 29 BEHG.

<sup>47</sup> According to Article 14 of the Real Decreto n. 1197, the relevant moment is the one of the publication of the interruption of dealing of the target securities..

<sup>48</sup> HOPT/ WYMEERSCH (1992), 120, 126, 234, 291-292.

<sup>49</sup> General Principle 7 and Rule 21. See STEDMAN (1993), p.400-405; FARRAR (1998), p. 598.

<sup>50</sup> § 12 ÜbG. See HUBER/ LÖBER (1999), p. 86-87.

<sup>51</sup> Article 575 of the 1991 Securities Markets Code. See, generally, MONTEIRO/ SÁ (1998).

<sup>52</sup> The text does not aim to use the expression *passivity rule* a negative sense, and recognizes that this rule still allows a large number of activities within the sphere of activity of the target company, which are legally not defined as frustrating action: see *infra*, 5.

<sup>53</sup> Article 183 Securities Code. See, critically, PEREIRA (2000), p. 182-187.

<sup>54</sup> NBK Recommendations, n. 13. The italic is not included in the original version.

**III** - The countries that do not directly settle this question have found themselves with difficulties in the application of the stand still rule.

This is, namely, considered as an interpretive problem in Italy, since the *Testo Unico* does not expressly define the moment from which the passivity rule should apply<sup>55</sup>. Under the Italian legal system, the question lies on which of the notices of the bid - the preliminary one or the definitive contractual announcement of the offer – should be considered as decisive for the purpose of impeding techniques aimed at frustrating the offer.

The matter was under discussion in the bid presented in September 1999 by *Generali* for *Ina*'s shares. *Ina* asked the supervisory authority for a clarification on whether article 104 would apply. After an affirmative answer from the *Consob*, *Ina* appealed before the courts, and received a different response. Both the Appeal Court and the Supreme Court concluded that only the formal announcement of the bid should be decisive for the effects of the passivity rule<sup>56</sup>.

## 5. Restricted acts from the board

**I** - Under European jurisdictions, there are two main models to ascertain the circle of impeded acts. That can be done either by the use of a general clause, pointing at the aim of the forbidden acts; or by presenting a list of inhibited actions to be undertaken by the board of the target company.

**II** - When the legal technique comprises a list of forbidden acts, it is usually a non-exhaustive one. Such is the case of German's Take-over Code that declares the duty of neutrality involves the prohibition during the offer, among others, of the issuance of new securities, of substantial changes in the assets or liabilities and of the conclusion of agreements outside the scope of ordinary business<sup>57</sup>.

Similarly, the Portuguese Securities Code forbids acts that materially affect the net asset situation of the target company, apart from day-to-day management, and which can significantly affect the objectives announced by the offeror. The Code adds a further list of examples of relevant changes in the net asset situation of the company.

**III** – The range of forbidden acts varies significantly within European countries. For instance, the question on whether the passivity rule should affect, not only the target company, but also related companies within the same group, is a dividing issue. Against the trend of most European countries, the Spanish<sup>58</sup> and German<sup>59</sup> legal systems give an affirmative answer.

The Economic and Social Committee of the European Union has, in this aspect, always asked for a moderate position in the Proposed Directive text. Regarding the original 1989 proposal, the Committee considered that the issue of shares previously approved by the shareholders should not conflict with Article 8, claiming that the use of authorised capital does not harm the shareholders' rights<sup>60</sup>. When analysing the revised version, it made notice to the fact that the prohibition should not function as a way to paralyse the offeree company's activity<sup>61</sup>. Finally, in relation to the 1996 proposal, the Committee considered that the prohibition should not apply *to the right to search for alternative offers*<sup>62</sup>.

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<sup>55</sup> DE MARCO (2000), p. 125-133; MECATI (2000), p.247; MOSCA (1999), p. 294-299; PICONE (1999), p. 137-141; PRESTI/ RESCIGNO (2000), p. 3-8.

<sup>56</sup> CHIAPPETTA/ RISTUCCIA (2000), p. 21-31; DE MARCO (2000), p. 133-141; MECATI (2000), p. 258-264; PRESTI/ RESCIGNO (2000), p. 8-27.

<sup>57</sup> Article 19 *Übernahmekodex*. See HOPT (1997), 391-392.

<sup>58</sup> Article 14 RD n.1197.

<sup>59</sup> Article 19 *Übernahmekodex*.

<sup>60</sup> OJ C 298/57-58, 27.11.89.

<sup>61</sup> OJ C 102/51, 18.4.91.

<sup>62</sup> OJ C 295/5, 7.10.96.

This last proposal was accepted in the Common Position (EC) n.1/ 2001 in view to adopting a Directive on take-overs, as it excludes the search of alternative bids from the concept of frustrating action<sup>63</sup>.

## 6. Submission to shareholder approval

**I** - The submission to shareholder approval represents, under the analysed European systems, the key element to find out the ratio of the prohibitive rule. This aspect leads to two main conclusions.

In the first place, it functions as a procedural tool to legitimise the adoption of defensive measures, which has been in other circumstances advocated as the right method to control defensive measures<sup>64</sup>. However, by doing so in every type of defensive measure<sup>65</sup>, it operates what has been designated as a “subversion” of the ordinary distribution of powers within a company<sup>66</sup>, putting into the hands of the general meeting powers that, under normal conditions, would be under the board’s discretion<sup>67</sup>.

Secondly, this aspect is connected with the intention to strengthen the freedom of shareholders regarding the bid. In the event of a transition of control, solely the shareholders have the power to decide the company’s fate<sup>68</sup>. It shows that the objective of the rule is to bring protection to shareholders.

**II** - The European Parliament, in relation to the 1997 proposal of the EC Directive, made the requirement that the general meeting should give the authorisation during the process of the offer<sup>69</sup>. This has influenced Portuguese law that waives the application of the stand still rule acts authorised by resolution of a general meeting *called specifically* for this reason during the term of the offer<sup>70</sup>.

Under Swiss law, however, this solution is expressly rejected, as shareholders’ approval is admitted whether the resolutions were passed prior or before the publication of the bid<sup>71</sup>.

**III** –The possibility of shareholders’ approval to decide take-over tactics has implication on the timetable of the offer.

In Belgium this point has been made very clear by stating that if a general meeting is called upon during the offer to decide on possible defensive action, the term of the offer will automatically be extended to a fortnight after the date of the general meeting<sup>72</sup>.

The timing of the bid may, nevertheless, be in some circumstances incompatible with urgent decisions the company has to take. Indeed, during the course of an offer, there may be unique opportunities that require immediate action from the board. One must remember that the process of globalisation implies intensive mergers and acquisitions, and the sole alternative is often between buying and being bought. At that time, paralysing strategic decisions for a month or two can prove to be highly detrimental to the company and its shareholders.

So, under the discussion of the Proposed EC Directive, the Economic and Social Committee of the European Union proposed an exemption for acts decided in case of urgency, to be subsequently ratified by the general meeting of shareholders<sup>73</sup>.

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<sup>63</sup> Article 9. 1. (a) of the Common Position (EC) n. 1/2001, in OJ C 23/1, 24.1.2001.

<sup>64</sup> PAZ-ARES (1996), 123-162.

<sup>65</sup> Both Belgium, German and Portuguese Law waives acts which result from the performance of obligations assumed before the knowledge of the presentation of the bid.

<sup>66</sup> WEIGMANN (1993), p. 570.

<sup>67</sup> The “subversion” is only partial, for there are some defensive measures within the normal powers of the general meeting of shareholders. See CHIAPPETTA (1998), 969.

<sup>68</sup> HOPT (1992a), 185; HOPT in SCHUSTER/ ZSCHOCKE (1996), p.225.

<sup>69</sup> VAZ (2000), p. 88.

<sup>70</sup> Article 182, n.3 b) Securities Code, approved by Decree Law n.486/99, 13<sup>th</sup> November. In complement to this prescription, article 181 2. d) obliges the target board to act in good faith namely concerning correction of information and honest behaviour.

<sup>71</sup> Article 29 BEHG.

<sup>72</sup> Article 26 Royal Decree 8<sup>th</sup> November 1989.

<sup>73</sup> OJ C 295/5, 7.10.96.

Similarly, the Swedish Recommendations on take-overs also state “the requirement of approval by a general meeting may be waived if it is clearly essential that action must be taken with the greatest possible speed, in view of the needs of the company and its owners”<sup>74</sup>. Therefore, it is here assumed that the protection of shareholders – that is the main reason for the stand still rule – implies waiving the submission to general meeting’s approval when urgent board decisions are required.

## 7. Liability for bids presented to start the “passivity rule”

**I** - The prohibition to decide upon some corporate matters can be seen as an advantage to the competitors of the target company who might feel tempted to present bids just to make the rule of neutrality apply.

This concern is tackled under the British City Code that imposes a passivity rule only in the case of a *bona fide* offer<sup>75</sup>.

Similar concerns are revealed under Swedish law, once the recommendation to prohibit defensive measures apply from the moment that the board or senior management has good reason to assume that a serious offer is imminent. This expression - *serious offer* - was admittedly used to “prevent any person from utilising this provision to prevent the Board or management from taking measures to appear to be desirable for the company or its shareholders”<sup>76</sup>.

**II** – However, under the heat of the hostile bid dispute, there may be some problems in assessing if the offer is a serious one or not.

To answer this issue, the Portuguese Code states that the offeror is liable for the damages incurred due to the decision to launch a take-over, taken with the main objective of placing the target company in a passivity situation<sup>77</sup>. The purpose of this prescription is to prevent abusive application of the stand still rule, namely from competitors in the same field of activity of the offeree.

**III** – It is also worth mentioning that the risk of abuse of prohibitive prescriptions from the offeror is diminished if the paralysing effect does not apply before partial bids. This led to recent changes under Portuguese law, where the stand still rule now only applies if the bid is presented to more than one third of the targeted securities. Nonetheless, this restriction is not reflected in the text of the Common Position, that applies the duty of neutrality both to partial and general bids<sup>78</sup>.

## 8. Conclusions

**I** – American and the European experiences on take-over defences are sharply contrasting. The model of evaluation of the take-over tactics differs between an *ex ante* prohibition and a possible *ex post* judgement. The American model possibly leads to significant court litigation over the board’s permitted range of action<sup>79</sup>, while the European approach could be said to favour legal certainty.

However, the flaws of most of the European systems become apparent when one analyses the criteria to distinguish the use and the abuse of defensive devices. Besides the unfinished discussion on both the rationale of defensive measures regulations and on empirical evidence, European legislation seems to adopt a straightforward position regarding defensive tactics. In fact, as shown previously in this paper, most European legal texts form a board opposition to frustrating action - i.e. to acts that might compromise the success of the offer – if they are not authorised by the general meeting of shareholders.

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<sup>74</sup> NBK Recommendation n. 13.

<sup>75</sup> General Principle 7 and Rule 21.

<sup>76</sup> NBK Recommendation n. 13.

<sup>77</sup> Article 182 n. 5.

<sup>78</sup> This is due to the broad concept of takeover bid presented in Article 2 (a): *a public offer made to the holders of the securities of a company to acquire all or part of such securities*.

<sup>79</sup> JENNINGS/ MARSH/ COFFEE (1992), p. 665-666; WEIGMANN (1993), p. 571-572; GARCÍA DE ENTERRÍA (1999), p. 163-165.

**II** - This prohibitive model, which has become more and more used in European legislation, can adequately solve clear-cut cases of management-entrenched anti-take-over defences<sup>80</sup>. Nevertheless, it faces many objections.

In the one hand, by focusing on the concept of frustrating action, it distracts European legislators from what should be the main task, that is, to find out the directors' duties in front of hostile take-overs.

On the other hand, from a practical point of view, by submitting every defensive measure to the approval of the shareholders, the Proposed EC Directive's philosophy risks at paralysing a significant part of the course of business of publicly held companies and at giving cause to many "unnecessary general meetings"<sup>81</sup>. As a corporate governance model, its weakness is clear in particular when urgent decisions need to be taken by the board of directors.

In theoretical terms, this model equally evidences a reverential view to the managerial passivity theory that was somehow popular in the U.S. in the early eighties<sup>82</sup>, but that has been losing importance especially since the Delaware Supreme Court 1986 *Revlon* sentence<sup>83</sup>.

From a systematic point of view, the mainstream European stand still model lacks coherence for, while it is extremely restrictive in what regards defensive manoeuvres, it shows a paradoxical complacency towards protective measures<sup>84</sup>.

Ultimately, this shows that the level of harmonisation regarding anti-take-over measures is incomplete under the proposed Directive. Companies from states with a strict passivity regime can feel themselves at a competitive disadvantage in relation to companies with complete freedom of movements during take-over bids. Differences occur in some European States but are notorious mainly when comparing European companies to non-European ones.

**III** - In spite of being a crucial area in the articulation between company law and securities law, the regulation of defensive mechanisms in Europe has, in substantial terms, revealed little evolution since the proposed Directive began to be discussed. There are, of course, refinements of a board stand still model in the Common Position (EC) n.1/ 2001 in view to adopting a Directive on take-overs and in recent European legal interventions – concerning, e.g. the initial moment of the "sensitive period"<sup>85</sup>, the implications on the time frame of the offer<sup>86</sup>, the right to search for alternative offers<sup>87</sup> and the liability for bids presented mainly to put in force this prohibitive rule<sup>88</sup>. Nevertheless, the whole model in itself has not proven to be the best.

Differential regulation according to the type of defensive action, which empirical evidence suggests as being the best approach, is far from being achieved. Other differentiating factors should be taken into account in future legislative work: e.g. the directors' alignment with shareholders interests, the offeror's purpose, the urgency of the decision, the economic foreseeable impact of the decision taken by the board, and the proportion of costs and risks involved in the defence regarding the bid presented. A wide-ranging debate is still needed to help drawing the line between permitted and forbidden defensive measures to be adopted by the board during the course of take-over bids.

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<sup>80</sup> Pointing out the recent Gucci affair as an example on how harmonization is needed in relation to defensive measures, see DAIGRE (2000), 339-340.

<sup>81</sup> SAVELA (1999), pp. 326-328, 345, 349-350.

<sup>82</sup> EASTERBROOK/ FISCHER (1981).

<sup>83</sup> HADDOCK/ MACEY/ McCHESNEY (1987), 118-149; FLEISHER/ SUSSMANN (1997), § 9.01. See also *supra*, 2. III.

<sup>84</sup> The remark belongs to WYMEERSCH (1992), p. 128.

<sup>85</sup> See *supra*, at 4.

<sup>86</sup> See *supra*, at 6, III.

<sup>87</sup> See *supra*, at 5, III.

<sup>88</sup> See *supra*, at 7.

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