Research Report in Finance and Banking

The Economics of the Proposed European Takeover Directive

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with
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EXECUTIVE SUMMARY

A widely held sentiment is that a coherent EU policy is needed for the regulation of takeover bids. In terms of policy aims, the Commission has been seeking for more than a decade to create the conditions for the development of an active cross-border market for corporate control. Progress towards a cross-border mergers and acquisitions market is hindered by the existence of 15 different national systems of takeover regulation and the retention of costly structural and technical barriers to takeovers. In fact, steps taken by the EU in 1996 to revive the plans for a regulatory framework for harmonising takeover law that would yield improvements for organisations and shareholders were undermined by certain member states opposed to a framework based on the British City Code on Takeovers and Mergers. Despite the failure in the European Parliament to pass the Thirteenth Directive in 2001, this did not alter the ambitions of EU policy-makers who recognise the importance of a cross-border takeover market for the evolution of capital markets and the efficient allocation of capital. In this context, the European Council held in Lisbon in March 2000, which established the objective for Europe to become the most competitive economy in the world, endorsed the re-introduction of a common framework for cross-border takeover bids. Ultimately, the passage of takeover legislation would serve to create the opportunities for firms to reposition themselves in the European market and signal that steps are being taken to foster liquid markets.

On 2 October 2002, the European Commission presented a new proposal for a Directive on takeover bids. Not surprisingly, the new draft relies on the basic principles of its predecessor. The new proposal has been improved significantly due the Commission's decision to incorporate some of the recommendations made by the Group of High-Level Company Law Experts. Notably, the new proposal provides a common definition of 'equitable price', and the introduction of squeeze-out and sell-out rights. In January 2003, the European Parliament published a working paper that recommends the application of the breakthrough provisions to multiple voting arrangements and a requirement that the bidder must pay 'fair compensation' to the holders of the shares broken through. In the meantime, MEPs, under the direction of the Committee on Legal Affairs and the Internal Market Rapporteur Klaus-Heiner Lehne, have proposed a number of amendments that would allow, inter alia, the application of the break-through rule to multiple voting arrangements, and permit member states to prohibit takeovers originating in third countries so long as EU bidders are hampered by poison pills and other obstacles to takeovers.

The proposed Directive is based on two key features – the mandatory bid rule and the prohibition against defensive measures initiated by the management board – which provide the model for the governing code on acquisitions. A third, major provision, found in Art. 11, prohibits any restrictions on the transfer of securities contained in articles of association and contractual arrangements during the period of acceptance of a bid. It is worth noting that the provision on pre-bid strategic embedded defences also covers legitimate arrangements that are ostensibly used by managers in a variety of situations besides the takeover context.

The report in a nutshell

1. European policy-makers should agree on clearly defined objectives and principles of corporate governance that create substantial benefits for shareholders. This could lead to higher firm valuations and lower costs of capital for firms.
2. Takeovers are about increasing efficiency. Their function is to reallocate existing physical and financial assets. They involve the distribution of funds to shareholders. Furthermore, takeovers act as an incentive to managers to increase allocative efficiency of investment funds.
3. In the area of takeovers, there is evidence that capital markets have the capacity to discriminate between different takeover bids based on the degree of transparency and of shareholder rights protection. This report shows that lower premiums are offered when the shareholder rights index of the bidding shareholders is high. When the accounting standards of the target firm are high, a higher bid for the target is made. Consequently, bidding firms are willing to pay relatively higher premiums for companies with better transparency created by higher accounting standards. The report also shows that a bidding firm is willing to pay a higher premium when the principle of one-share/one-vote is upheld by the target firm – this means that there are no pyramids or multiple voting shares – a higher premium is offered for the target shares. The proposed Directive could help to make markets more transparent and improve the efficiency of the market.
4. The level playing field principle, which consists of the break-through rule and the board neutrality rule introduced by the High Level Group, remains vague and capable of causing conflicting interpretations. Each of the proposed measures in the takeover bids Directive should be analysed on its own merits.
5. The underlying economic claim for the level playing field is that differences in regulatory arrangements distort the conditions of competition. The fairness claims about the differences in laws and policies of non-EC nations are based solely on a distributive rather than allocative efficiency argument.
6. The level playing field for takeovers is not a suitable yardstick for takeover regulation. From a social welfare point of view, policy-makers should adopt policies that encourage value-creating bids and discourage value-decreasing bids. Any proposal that would result in a regime that screens out value-increasing takeovers – based on differences in regulation – cannot be defended on a procedural or substantive basis. Ultimately, of course, such a policy would result in lower efficiency gains overall which is contrary to aims of the legislation.

7. EU takeover regulation must attempt to locate an optimal balance between harmonisation and diversity. On the one hand, the benefit of the proposed Directive lies in the provision of simple common rules that avoid some of the cost and difficulties of complex rules of differing national regimes (e.g. board neutrality). On the other hand, it is far from clear that member states with different laws and traditions will be served by proposals of the European Parliament that mandate additional change at the national level (e.g. threshold level).
8. The mandatory bid rule is a sound device to prevent expropriation from minority shareholders. The mandatory bid also eliminates the two-tier discriminatory bid, which limits the pressure to tender problem. The Commission's equitable price proposal is simple and demanding on the bidder, ensuring that some value-increasing bids may fail. The report endorses the view that member states should be allowed to set the thresholds for mandatory bids. This policy is reasonable given the variations in national legal traditions across the EU.
9. There are good reasons to reject the break-through rule. At the level of theory, there is no question that it violates the principle of shareholder decision-making, which is used by the High Level Group to justify the principle of board neutrality. There is also a logical inconsistency between the break-through rule and the mandatory bid rule.
10. We do not see any immediate need to include a break-through rule in the directive. As long as the market is transparent, it will be able to price capital structures – and, if they are considered to be value-decreasing, raise the capital cost for the company concerned.
11. Assuming, however, that a break-through rule is adopted, the scope seems arbitrary if some deviations from the one-share/one-vote rule are included and others are not. Multiple voting shares have in principle the same economic effect as preferred shares or shares with restricted transferability or shares where the voting right is acquired after two years' holding.
12. Assuming that the break-through rule is adopted into legislation, it is submitted that bidders should compensate the holders of dual and multiple class shares that have been broken through. Requiring compensation to the holders of special voting rights will not frustrate the legislative aim of the Directive, *viz*., the creation of a European market for corporate control.
13. The European Parliament Working Paper's recommendation to pay 'fair compensation' to the holders of shares that are broken through is unconvincing, not because compensation is unnecessary but because the proposed rule would actually reverse causality: the compensation rule would determine the premium. As a consequence, it is likely that the Directive could be challenged on the basis that compensation was inadequate.
14. To the extent that the break-through provisions affect acquired rights, the system by which compensation is calculated should be sufficiently flexible to take full account of the diverse circumstances of the deprived shareholders.
15. If a break-through rule was adopted, the report favours grandfathering the existing dual- and multiple-class shares for a substantial period of time. We believe that this

position has the advantage that compensation might not be necessary or, if so, at very low levels.

16. The report rejects the view that a sell-out right given to the holders of multiple voting rights based on a price presumption is a means for compensation. In practice, such a right is likely to have no effect.
17. The report supports the Commission's approach on board neutrality. The principal argument in favour of this approach is that it limits the potential coercive effect of a bid. Whilst there may be circumstances in which the target management has better information than the market, the proposed Directive allows for ample opportunity for the incumbent to reveal their business plans to shareholders. Takeovers are an opportunity where shareholders are given the opportunity to assess the performance of the incumbent management team compared with a rival.
18. Even though it would appear that some exceptions to board neutrality are justified (e.g., reserve authorisations), they would come at the cost of less transparency. Board neutrality should, moreover, be endorsed because it offers, in light of some national company law regimes, some degree of simplicity into the regulatory framework.
19. Under Art. 14 of the proposed Directive, a majority shareholder can exert a squeeze-out under the constraint that he holds between 90% and 95% of the capital following a full bid. In principle, the proposed squeeze-out rules are acceptable but they leave too much room for national peculiarities. In this regard, appraisal proceedings should be discouraged in favour of simpler methods
20. The proposed Directive should not be restricted to bidders from the EU. When bidders compete for a target, shareholders will benefit ultimately. To be sure, when the same rules apply to all bidders, it is less complicated for shareholders to make an informed decision about a bid. However, there should be no attempt to level the playing field with the US. Harmonisation claims that are based on fair competition (and would justify protectionism) would mean undertaking measures that cannot be justified from an efficiency point of view.
21. Since the aim of the proposed Directive is to encourage value-increasing takeovers, it matters little whether the bidder originates from the US or the EU. Thus, efforts to frustrate this end by adopting legislation that benefits a small group at the expense of most groups in the EU is certainly a strong argument against the Commission's attempt to harmonise EC takeover law.
22. Proposals to allow the national securities regulator to frustrate takeover bids if the bidder has some degree of market dominance in its home country should be rejected. This would imply that the securities regulatory authority would have to decide on issues of market dominance. To overload the takeover Directive with issues of market dominance would create conflicts between the competition authorities and securities regulator.

Policy recommendations

To begin with, it is clear that the level playing field idea does not offer useful guidance in the policy debate. Claims based on the idea of the level playing field dominate the legislative history of the takeover bids Directive. Unfortunately, as pointed out by a number of experts, the concept has many different meanings. The demand for equivalent access has little normative support in the established rules and structures of the international economy.

As should already be apparent, the debate on the takeover Directive should focus on the efficiency implications of the proposed legislation. In this sense, competitive forces in European capital markets should be strengthened by improved transparency. It is also important to emphasise that corporate governance has a direct impact on corporate performance through market prices. Well governed bidders will find it easier to raise capital to finance an acquisition. This argument, of course, does not require the creation of a level playing field instituted by statute. Overall, there are gains to be achieved by creating an active cross-border takeover market that protects minority shareholders and promotes higher disclosure standards. A European takeover Directive should thus include provisions that improve transparency for bidders across the European Union.

Moreover, the proposed Directive should include:

- a mandatory bid rule requiring that a bidder must make an equitable offer to all shareholders;
- the ‘level of control’ should be left for the member states to determine;
- a simple rule that restricts target management intervention after the bid is made to simply expressing its own view about the proposed takeover bid; and
- a simple and efficient rule on squeeze-outs.

A break-through rule will not contribute to transparency and will complicate bids and raise legal costs. Consequently, we recommend rejecting the inclusion of a break-through rule in the proposed Directive.

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1. Introduction

On 2 October 2002, the European Commission presented a new proposal for a Directive on takeover bids in an effort to harmonise takeover regulation across the European Union. The Commission's policy of promoting an active market for corporate control is designed to make it possible for shareholders to introduce new management teams that can increase firm value and to discipline insiders with the threat of a hostile takeover. Naturally, facilitating the development of a hostile takeover market is designed to have an impact on the corporate governance arrangements of continental European countries, which have relied, until recently, on a different set of financing and monitoring arrangements than the United Kingdom. In the context of the ongoing debate over the EU-wide harmonisation of takeover regulation, this report analyses the design of the High-Level Group (HLG) report and the proposed Directive as well as examines the necessity and rationale for harmonisation of takeover regulation in the EU.

The proposed Directive is based on the principles of shareholder decision-making and proportionality between risk-bearing capital and control, which must in connection with some pre-bid structures of a target company ensure a level playing field. It focuses on three types of transactions: takeovers in general, mandatory bids and certain types of squeeze-outs. It aims at setting certain minimum guidelines for corporate conduct and transparency in the takeover context. The areas of national law covered in the proposed Directive include: disclosure on the bid, board neutrality, mandatory bid, mini-break-through rule, squeeze-out and sell-out rights, employee rights and transparency.

The level playing-field concept, introduced by the HLG, remains vague and susceptible to conflicting interpretations. In the main, the level playing-field concept is a rule of reciprocity between jurisdictions. A central issue in this debate on the proposed Directive is whether the break-through rule and board neutrality are necessary to create a level playing field for takeover bids. To the High Level Group, such legal rules are, in the absence of efficient capital markets, necessary for overcoming national barriers to a control transfer and ensuring that self-interested managers can use these measures to resist a bid. To others, the break-through rule, on the contrary, would serve to frustrate contractual promises between shareholders and the firm, and reduce the value of a target firm's shares. Naturally, there are trade-offs between the board defence and shareholder choice models. However, in the presence of agency costs, we argue that the shareholder choice mode is more desirable, particularly in the context of inefficient capital markets, to protect investor interests and allow them to express their preferences with regard to the bid. Thus, there is a strong case that board neutrality and the break-through rule should be assessed on their own merits.

This report provides a detailed analysis of the mandatory bid rule. It examines the implications of the rule, taking into account its *ex-ante* and *ex-post* trade-offs. The report outlines clearly the valuable features of the mandatory bid rule in safeguarding against value-decreasing takeovers, and assesses whether the Commission's decision to allow member states to define the threshold for the mandatory bid is a sensible approach. The Report also outlines the main elements of the break-through rule and assesses the profound changes that would take place in Europe's takeover market should the rule be adopted. We make a number of recommendations. The report identifies a number of factors that supply good reasons for rejecting the break-through rule. These include the fact that it violates shareholder decision-making, is logically inconsistent with the mandatory bid rule and may create problems associated with two-tier takeovers. Moreover, evidence on the efficiency implications of dual-class shares is inconclusive. The report concludes that, having highlighted the costs and benefits of the proposed break-through rule, the higher costs associated with the break-through rule outweigh the benefits.

Proponents of the break-through rule endorse a fair compensation approach to compensate holders of dual-class and multiple class shares affected by the break-through rule. Arguments for a fair compensation procedure to compensate multiple-class shareholders are unconvincing, not because compensation is unnecessary but because the proposed mechanism would actually reverse causality: the compensation rule would determine the premium. As a consequence, the report argues that it is very likely that the voting premium, which currently ranges from 5% to 80% across the EU, would move toward the proposed 15%. The report also clearly outlines alternative compensation procedures.

The report favours the approach of the Commission to strict board neutrality. Under this view, the management board of the target firm is restrained from taking actions that could frustrate the success of the takeover bid. The principal argument in favour of this approach is that it limits the coercive effect of a bid. Against this background, the issues on the debate on the proposed Directive relate to the extent to which board neutrality is required. The report suggests when there is a choice between two alternative regulations (board neutrality vs. managerial veto), the EU should adopt in general the rule that is more favourable to outsider shareholders since it is more likely to be changed over time. In this context, the report endorses board neutrality since it works against the opportunistic behaviour of incumbent management.

The report also outlines the squeeze-out rules proposed in the proposed Directive. The proposed thresholds beyond which a squeeze-out can be initiated still reflect national legal history. Since these thresholds are to some extent arbitrary, our analysis suggests that they may just as well be harmonised for sake of simplicity. Furthermore, the report notes that it may be of little cost to streamline the rules such that an independent expert valuation is eliminated from the fair price determination. Moreover, the fair price presumption itself could also be streamlined.

The report is comprised of three main parts. Part I (Sections 2-5) provides a summary of the most important features of a corporate governance system, the differences in the ownership and control structures in Europe and a brief history of takeover bids in the US and EU. Part II (Sections 6-8) offers an analytical backdrop to determinants of bid premiums and develops a framework to understand whether corporate governance

factors can explain the cross-sectional variation in premiums paid in takeovers while controlling for the characteristics of the bid. Part III (Sections 9-13) discusses the proposed Directive, discussing the mandatory bid rule, the break-through rule, board neutrality, squeeze-out rules and the level playing-field concept.

To set the context of the discussion of the regulation of takeovers, this report commences in Section 2 with a discussion of the consequences of good corporate governance for the development of a strong and deep capital market. We present research that shows that higher quality disclosure gives investors an enhanced level of protection that increases the accuracy of asset pricing and has an impact on investor confidence. In Section 3, we present the main features of the cross-country patterns of ownership and control in Europe. Our analysis of the differences in ownership patterns has important implications with regard to corporate governance. We show that shareholding concentration is much higher in continental Europe than the UK, bank holdings are generally small in all countries unless they are part of a financial group and that institutions and directors are the main shareholders in the UK, but do not hold much voting power.

As a backdrop, Section 4 provides explanations for the differences in concentrations across companies and countries. This section documents the corporate law mechanisms that allow controlling shareholders in continental Europe to obtain greater premium for their shares. In Section 5, we shift our focus to examine the main features of the takeovers in the United States and the European Union. In particular, we report on the value and size of deals in the EU during the fifth takeover wave as well as the means of payment. In Section 6, we examine the determinants of bidder and target returns. In our analysis, we identify the variety of profitability drivers, noting that the main motive for mergers and acquisitions is the value created from buyer and seller synergies. In Section 6, we review the empirical evidence on bidder returns. Section 7 investigates the impact of the composition of the takeover bid, of the characteristics of the bidding and target firms and of the regulation of the different European countries on the premiums paid for target firms. In particular, we examine whether differences in corporate law, especially in shareholder protection, influence the price paid for target shares. In Section 8, we examine whether corporate governance variables can explain some of the cross-section variance in the premiums paid in takeovers. We show that corporate governance rules are important. Bidding firms will pay higher prices for target firms that have higher transparency and accounting standards. In Section 9, we focus briefly on the legislative history of the proposed takeover bids Directive and examine the key features of the High Level Group's recommendations. While the last sub-section of Section 9 supplies a brief overview of the newly proposed legislation, Section 10 goes on to address the main features of the mandatory bid and break-through rule. In Section 11, we shift our focus to board neutrality and consider whether there is a good case for boards to intervene *ex post* in the takeover process. In Section 12, we examine the proposed squeeze-out rules with respect to the differences across countries. Finally, we discuss, in Section 13, the concept of the level playing field for takeovers.

PART I

2. Corporate Governance and the Cost of Capital

Investors value good corporate governance. Discussions of corporate governance systems tend to identify a link between investor protection and the development of a country's capital market. Additionally, some argue that the greater the protection afforded to minority shareholders and creditors, the greater the probability that firms will receive external financing at a lower cost of capital. Not surprisingly, this issue has figured prominently in policy discussions in recent years regarding the corporate governance practices that companies should embrace.

Recent research explores the effect of corporate governance on stock market valuation. The work of La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998, 1999, 2000) is responsible for developing this new line of research to explain the differences in corporate governance systems by referring to the level of legal protection provided for minority shareholders and the degree of capital market development. La Porta et al. found that common law systems tend to outperform civil law systems by adopting legal rules that offer better protection both for expropriation of shareholders by management and the violation of the rights of minority shareholders by large shareholders. In their study of 49 countries, they classified these countries according to the origin of laws, quality of investor protection and quality of law enforcement. Moreover, they investigated the extent to which a country adheres to the one-share/one-vote rule. A shareholder protection index was constructed which determined *inter alia* whether proxy voting by mail is allowed, whether minority protection mechanisms are in place and whether a minimum percentage of share capital entitles a shareholder to call for an extraordinary general meeting. Creditor rights are aggregated into an index that is higher when the creditor can take possession of the company in case of financial distress, when there are no restrictions on workouts and corporate reorganisations and when the absolute priority rule is upheld. Finally, the rule of law index produced by the rating agency, International Country Risk, indicates the country risk and the degree to which laws are enforced.

Both the shareholders and the creditors are best protected in common law countries and receive the least protection in French civil law countries (see Table 1). The Scandinavian and German countries come somewhere in between. The implication of La Porta et al.'s work is that countries should move towards the more efficient common law system based on transparency and arm's length relationships.[1]

[1] Some argue that the theoretical framework developed by La Porta et al. is too limited for analysing governance issues in developing countries (Berglöf and von Thadden, 1999). For instance, Berglof and von Thadden argue that La Porta et al.'s focus on protecting minority shareholders and creditors is far too narrow even to be applied to most European countries. Moreover, they also pay more attention to the protection of external finance and tend to ignore other important constraints on firm growth. By emphasising the importance of dispersed ownership, the approach of La Porta et al. only appears relevant to the developing country context. Others argue that there have been significant changes over the last 20 years in the pattern of developing markets finance. The differences in corporate and legal rules cannot easily account for the differences in financial arrangements in emerging markets (Glen, Lee and Singh, 2000). There are also not many companies that are covered by the La Porta et al. study.

Table 1. Shareholder and creditor protection

	Shareholder protection	One-share/ one-vote	Creditor protection
UK	4	0	4
US	5	0	1
English origin average	3.39	0.22	3.11
France	2	0	0
Belgium	0	0	2
Italy	0	0	2
Spain	2	0	2
Portugal	2	0	1
Netherlands	2	0	2
French origin average	1.76	0.24	1.58
Germany	1	0	3
Austria	2	0	3
Switzerland	1	0	1
Japan	3	1	2
German origin average	2.00	0.33	2.33
Denmark	3	0	3
Finland	2	0	1
Norway	3	0	2
Sweden	2	0	2
Scandinavian origin average	2.50	0.00	2.00
Overall average	2.44	0.22	2.30

Notes: One-share/one-vote is a dummy variable which equals 1 if one share carries one vote (no multiple-class voting rights). The shareholder protection index is higher if shareholders can mail their proxy votes, are not required to deposit their shares prior to the general meetings, cumulative voting is allowed, minority shareholders are protected and a minimum percentage of share capital allows a shareholder to call for an extraordinary general meeting. The creditor rights index is higher if absolute priority is followed in case of financial distress.

Source: La Porta et al. (1998).

Other studies show analogous correlations. For example, the level of shareholder protection has been shown to relate inversely to the size of the premium over the market price paid for a majority voting block – higher premiums are commanded in countries with weak protections (Zingales, 1994). A direct connection between strong shareholder protections and the volume of initial public offerings has also been shown (see Table 2). What these studies tend to confirm is the comparative advantage of countries that protect investors' interests. Recent empirical work by La Porta et al. (2000) found that firms operating in jurisdictions with strong shareholder protections have higher growth potential, as measured by Tobin's Q.

Table 2. External finance and legal origin

	External capital/GDP	Listed domestic firms/population	IPOs/ population	Debt/GDP
UK	1.00	35.68	2.01	1.13
US	0.58	30.11	3.11	0.81
English origin average	0.60	35.45	2.23	0.68
France	0.23	8.05	0.17	0.96
Belgium	0.17	15.50	0.30	0.38
Italy	0.08	3.91	0.31	0.55
Spain	0.17	9.71	0.07	0.75
Portugal	0.08	19.50	0.50	0.64
Netherlands	0.52	21.13	0.66	1.08
French origin average	0.21	10.00	0.19	0.45
Germany	0.13	5.14	0.08	1.12
Austria	0.06	13.87	0.25	0.79
Switzerland	0.62	33.85		
Japan	0.62	17.78	0.26	1.22
German origin average	0.46	16.79	0.12	0.97
Denmark	0.21	50.40	1.80	0.34
Finland	0.25	13.00	0.60	0.75
Norway	0.22	33.00	4.50	0.64
Sweden	0.51	12.66	1.66	0.55
Scandinavian origin average	0.30	27.26	2.14	0.57
Overall average	0.40	21.59	1.02	0.59

Notes: External capital is defined as the equity capital held by shareholders other than the largest three shareholders. Initial public offerings are companies that are brought to the stock exchange. Debt is here defined as the sum of the issued corporate bonds and the funds provided by banks.

Source: La Porta et al. (1997, 1998, 2000).

Furthermore, Lombardo and Pagano (2002) find that better legal institutions influence equity rates of return and the demand for equity finance by companies. They offer two reasons: good laws and efficient courts 1) curtail the private benefits of managers and 2) facilitate the contractibility of corporate relations with customers and suppliers and the enforceability of such contractual relations. In a context of better corporate legislation and more efficient courts, corporate profitability and growth will be higher, thereby raising the amount of external financing. Better legislation leads in the Lombardo and Pagano model to a reduction of managerial benefits by introducing legal limits to transactions with other companies that may dilute the income rights of minority shareholders. Better legislation, i.e. class action suits or voting by mail, is also leading towards a reduction of the legal and auditing costs that shareholders must bear to prevent managerial opportunism. They conclude that the size of these effects on the equilibrium rate of return is increasing in the degree of international segmentation of equity markets.

For the most part, these studies document the effect of better corporate governance protection on financial market development.[2] Recent research looks at the effect of corporate governance rules on firm valuations within a single jurisdiction. In the context of market-based systems, which are characterised by dispersed equity holdings, a portfolio orientation among equity holders and broad discretion of management to operate the business, shareholders are protected from abuse by an effective market for corporate control, a well functioning board of directors and strong fiduciary duties. Gompers, Ishii and Metrick (2003) create a governance index for US firms based on a large set of corporate governance provisions and focus on the relationship between governance and corporate performance. They provide evidence from 1,500 US large firms that the firms with strong shareholder rights are associated with higher Tobin's Qs, higher profits, higher sales growth, lower capital expenditures and fewer acquisitions. Consistent with the theory of La Porta et al. (2000), firms that adopt stronger shareholder rights create substantial benefits for shareholders.

Similarly, Drobetz, Schillhofer and Zimmermann (2003) further develop the one-country approach pioneered by Gompers et al. (2003), which links the relationship between strong shareholder rights and the long-run performance of a cross-section of German firms. They classify corporate governance rules into five categories to construct a governance index, which is related cross-sectionally to leading measures, including dividend yields, price-to-earnings ratios and book-to-market ratios. The evidence from Germany is broadly consistent with the central insights of the study by Gompers et al. (2003): there is a significant relationship between strong investor protection rules and firm value. Using price-to-earnings ratios, dividend yields and historical returns to proxy the rate of return on capital, Drobetz et al. (2003) provide evidence that for the sample period, from 1 January 1998 to 1 March 2002, the price-earnings ratios and market-to-book ratios are positive, which implies, in turn, that better protection of shareholders leads to higher firm valuations.

The wealth of recent empirical studies that focus on the corporate governance system as the independent variable in a cross-section of countries combined with the evidence from Germany and the United States in support of the La Porta et al. (1998) theory suggest that good corporate governance is among the most important factors for determining the cost of capital.

3. The Pattern of Ownership and Control in Europe

Corporate structures and ownership differ among countries and across economies. The recent empirical literature provides some international comparisons of ownership concentrations across western countries. Barca and Becht (2001) analyse cross-country ownership patterns in Europe. Figures 1 and 2 show that most continental European countries are characterised by majority or near-majority holdings of stock held in the hands of one, two or a small group of large investors. In contrast, the market-based system, which is found in the US and Commonwealth countries, is characterised by

[2] Although these studies provide evidence on the relationship between legal rules and the cost of capital in a cross-section of developed and developing stock markets, some argue that the studies are limited because the direction of causality between the legal system and the financial structure runs in the opposition direction, *viz.* financial structure prompts transformations taking place in legal regime (Bolton and van Thadden, 1998; Bebchuk and Roe, 2000).

dispersed equity holdings, a portfolio orientation among equity holders and broad discretion on the part of management to operate the business.

Figure 1. Percentage of listed companies under majority control

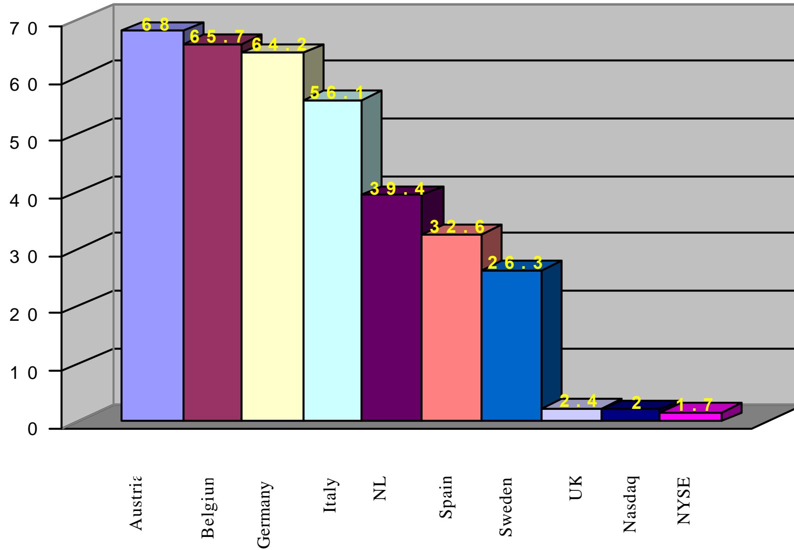

Figure 2. Percentage of companies with a blocking minority of at least 25%

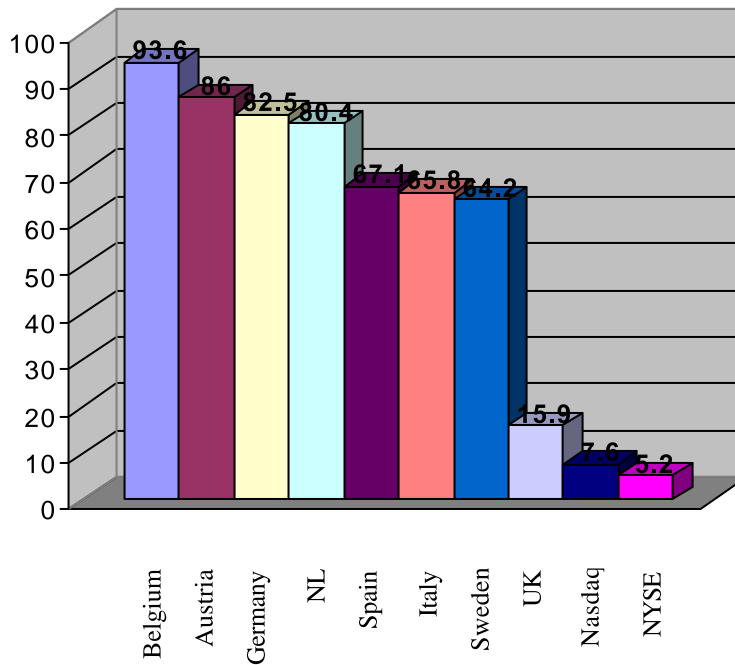

Table 3 shows further that the high degree of ownership concentration in continental Europe is striking; in French, German, Austrian, Belgian and Italian companies, a single

shareholder (or a shareholder group) usually owns an absolute majority of shares. This stands in sharp contrast with the US and the UK, where the largest shareholder owns an average stake of respectively 22.8% and 14%. Whereas a coalition of the three largest share holdings gives a cumulative share stake of more 60% in continental Europe (up to a super-majority of 75% in France and Austria), a similar coalition can vote a mere 30% of the shares in Anglo-American countries.

Table 3. Ownership distribution of largest shareholders in Western economies

		Shareholdings			
1996	Sample	Largest	2nd largest	3rd	4-10th
France[1]	403	56.0	16.0	6.0	5.0
Austria[1]	600	82.2	9.5	1.9	6.5
Italy[1]	214	52.3	7.7	3.5	5.1
Netherlands[2]	137	28.2	9.2	4.3	7.1
Spain[1]	394	38.3	11.5	7.7	10.3
UK[2]	248	14.0	8.3	6.1	9.2
		Largest	2nd + 3rd	4 + 5th	6-10th
Belgium[1]	135	55.8	6.9	0.6	0.2
Germany[1]	402	59.7	8.6	2.6	0.3

Note: This table gives the size of the largest ownership stakes for European countries and the US. Ownership data are for 1996 (all countries) and 1994 (Belgium). The sample companies in all countries are listed, the Austrian sample consists of both listed and non-listed companies.

[1] Both direct and indirect shareholdings are considered.

[2] Only direct shareholdings.

Sources: Gugler, Stomper, Zechner and Kalls (2001), Becht, Chapelle and Renneboog (2001), Bloch and Kremp (2001), De Jong, Kabir, Marra and Roell (2001), Crespi and Garcia-Cestona (2001), Bianchi, Bianco and Enriques (2001), Becht and Boehmer (2001), Renneboog (2000), Franks, Mayer and Renneboog (2001).

Furthermore, Table 4 shows that not only share concentration is different across countries, but that the main categories of owners also vary substantially across Europe and the US. The main shareholders are classified in i) institutions (banks, insurance companies, investment and pension funds), ii) individuals (excluding directors) and their families, iii) directors and their families and trusts, iv) industrial, commercial and holding companies, and v) the federal or regional governments. For each of these categories, we total the voting shares they control directly (by owning shares directly in a target firm) as well as indirectly (as ultimate owners using intermediate ownership vehicles). In other words, we combine the voting shares controlled by an ultimate owner at the top of the ownership pyramid (see infra). Such pyramids or ownership cascades are frequently used in most continental European countries.

In France, the shareholder category of industrial and holding companies owns on average 34% of the shares. In Belgium, this number is even higher at 37%.[3] German industrial and commercial companies own an average stake of 21% in other German

[3] The distinction between an industrial holding company (or conglomerate) and a financial holding company is often difficult to make across countries and therefore industrial companies and holdings companies are considered as one ownership category. The average cumulative ownership of share stakes in excess of 5% that is held by French and Belgian holding companies is 21% and 27%, respectively.

listed firms, or, from a different angle: in 52.4% of the sample companies, an industrial shareholder holds an average stake of 40%. This strikingly high concentration in hands of the corporate sector is also present in Spain, Italy and Austria. In contrast, the industrial and commercial sector of the UK and the Netherlands owns less than 11% of the listed companies.

Table 4. Ownership distribution of largest shareholders in Western economies, by different investor classes

	Sample	Ownership	Individuals and families	Banks	Insurance companies	Invest-ment funds	Holdings and industrial companies	State	Directors
France	403	[2]	15.5	16.0	3.5	0.0	34.5	1.0	0.0
Austria	600	[2]	38.6	5.6	0.0	0.0	33.9	11.7	0.0
Italy	[1]	[2]	68.6	7.2	0.0	0.0	24.2	0.0[4]	0.0
Netherlands	137	[3]	10.8	7.2	2.4	16.1	10.9	1.3	0.0
Spain	394	[2]	21.8	6.6	8.8	0.0	32.6	0.0	0.0
Belgium	155	[2]	15.6	0.4	1.0	3.8	37.5	0.3	0.0
UK	248	[3]	2.4	1.1	4.7	11.0	5.9	0.0	11.3
Germany	402	[2]	7.4	1.2	0.2	0.0	21.0	0.7	0.0

Note: This table gives the total large share holdings (over >3% or >5%) held by different investors classes. For all countries the ownership data cover the year 1996, except for Belgium (1994) and the UK (1993).

[1] Numbers for Italy refer to both listed and non-listed companies; for other countries only listed companies are taken.
[2] Both direct and indirect shareholdings are considered.
[3] Only direct shareholdings.
[4] Of the listed Italian companies, about 25% are directly and indirectly controlled by state holdings; this is classified in previous column under (State) Holdings and industrial holdings.

Sources: Gugler, Stomper, Zechner and Kalls (2001), Becht, Chapelle and Renneboog (2001), Bloch and Kremp (2001), De Jong, Kabir, Marra and Roell (2001), Crespi and Garcia-Cestona (2001), Bianchi, Bianco and Enriques (2001), Becht and Boehmer (2001), Renneboog (2000), Franks, Mayer and Renneboog (2001).

In continental Europe, direct share holdings in the hands of banks are generally low. For example, in Germany, only 5.8% of the stakes of 5% or larger are held by banks. However, German banks' influence is higher than these numbers imply as investors depositing their bearer shares at the bank can allow the bank to exercise these proxy votes. Furthermore, the banks can also have additional influence on the (supervisory) board as a result of the debt granted to companies. Bank shareholdings average between 0.5% and 11% in Belgium, Italy, Spain and the Netherlands, whereas bank ownership in Anglo-American countries is negligible. Although direct French bank shareholdings above 5% in the French corporate sector average only to 2.7%, Table 4 shows that when the real bank voting power is taken into account by adding the indirect power of financial groups, bank voting power rises to 16%. Conflicts of interest constitute the main reason why direct bank shareholdings in listed companies are low in most countries (Goergen and Renneboog, 2001). As banks owning corporate shareholdings frequently have also granted loans, the bank will have two different types of claims on the company. When there is a danger of bankruptcy and the bank faces a refinancing demand of the corporation, the creditor claims might encourage the bank to make the company file for receivership, whereas the equity claims might entice the company to revolve the bank loans and increase the riskiness of the firm's investment projects. Such conflicts of interest might even be exacerbated by the fact that in countries like France, Belgium and Italy, part of the bank's equity is held by large industrial holdings that also

own large shareholdings in listed companies to which that bank has granted bank loans (Renneboog, 2000).

Investment and pension funds and insurance companies hold important shareholdings in the UK and the Netherlands, where such institutions are the main shareholders with an average of 16% and 19%, respectively. Large stakes (of 5% or more) are rare in the other European countries, but this does not imply that the total percentage of shares owned by institutions is small. For example, in Belgium, insurance companies hold, in aggregate, more than 12% of the Brussels stock market capitalisation, and investment and pension funds account for about 20%. Still, such holdings are not required to be disclosed as individual stakes usually do not exceed the transparency thresholds of 5%. The foregoing point about the pattern of concentrated share ownership suggests that, in contrast to the Anglo-American countries, there is little in the way of 'shareholder activism' that can be expected from continental European institutions, given the insider trading legislation, the relative size of institutional shareholdings and the costs of corporate monitoring. Indeed, serious questions arise whether Anglo-American-style institutional shareholder activism would have good results in such a context. For some scholars, minimal takeover activity is a precondition of relational engagement between institutional shareholders and managers (Bratton and McCahery, 1999).

Table 4 reveals moreover that individuals and families account for about 15-25% of the large share stakes of listed companies in continental Europe.[4] In fact, Franks and Mayer (2001) have found that large-scale family ownership is an especially pronounced feature of the largest German firms. This finding was also documented by Becht and Boehmer (2001): in 37% of their sample companies, individual (or family) shareholders own an average stake of 20%. In the case of the UK, directors' holdings (two-thirds of which are executives) are, along with the institutional ones, the most important category of owners. The fact that managers hold large share stakes in some UK companies makes them somehow unaccountable to corporate control. For instance, Franks et al. (2001) show that voting rights in the hands of executive directors lead to managerial entrenchment and resistance to disciplinary actions undertaken against the management.

In this section, the analysis of differences in ownership structures has important implications with respect to corporate governance. The basic picture is clear: i) shareholding concentration is much higher in continental Europe than in the UK (and the US); ii) pyramidal and complex ownership structures are set up in continental Europe, mostly via intermediate holding companies, to retain control while relaxing the wealth constraints; iii) the continental European corporate sector owns a large stake in itself; iv) bank holdings are generally small in all countries unless they are part of a financial group; v) institutions and directors are the main shareholders in the UK, but do not hold much voting power in continental Europe; and vi) director ownership is high in the UK and leads to managerial entrenchment.

[4] The high number of family ownership in Italy and Austria is influenced by the fact that the sample consists of both listed and non-listed companies. Still, a majority of the listed Italian companies are family-controlled.

4. Explanations for Differences in Ownership and Control Concentration across Companies and Countries

When a diffuse ownership structure coincides with weak shareholder voting power, there may be serious agency conflicts between management and shareholders as a result of a lack of monitoring. A shareholder bears the full cost of corporate monitoring whereas he only enjoys the potential increase in corporate value resulting from increased monitoring relative to his own share stake. Therefore, only a large share stake gives sufficient incentives to monitor a company. A diffuse ownership and control structure may therefore lead to insufficient monitoring as a consequence of free riding on control. The advantage of such a control structure is increased stock liquidity and the fact that the market for corporate control may assume a monitoring role. Strong ownership and voting power concentration gives the opposite picture: liquidity is low but the presence of a large shareholder exercising strong voting power reduces managerial discretion to deviate from the principle of shareholder value maximisation. These base cases are panels A and D of Table 5, which one would expect to represent most Anglo-American companies (dispersed ownership and control) and most continental European and Japanese firms (concentrated ownership and control), respectively.

The case in which concentration of voting power is lower than that of ownership is exhibited in panel C. This can occur through the use of voting caps, which are designed to prevent large shareholders from exercising control. Interestingly, the resort to the use of voting caps, which disperses voting power, enables small shareholders to be protected, but it also may heighten the need to increase pressures on monitoring. In contrast to voting rights restrictions, the use of proxy voting can have a positive impact on the incentives for monitoring and control, while allowing the investors to diversify. Such voting caps were until recently used in Germany. When a company is in 'imminent danger', voting cap restrictions could be used. As such, corporate takeovers were affected by special voting rights measures designed to make the target more difficult to acquire. For example, Franks and Mayer (1999) have show that in the three corporate takeover battles in Germany since WWII, voting rights restrictions were introduced. As a consequence, the voting power of several large share stakes was reduced from for instance 40% to 5%. The fact that these three takeover attempts failed confirms our earlier observation that voting caps will likely result in a reduction of takeover activity and blockholder domination.

Panel B shows that it is possible to have a dispersed shareholding base with concentrated voting power. Concentrated ownership can be exercised to extract private benefits from minority shareholders. The corporate law regimes in most of these countries include a number of mechanisms that allow controlling shareholders to be able to obtain greater premiums for their shares. Such disparity between ownership and control is characteristic of countries that permit the exploitation of corporate opportunities. The most widely used mechanisms to accumulate control power with a limited investment are ownership pyramids or cascades, which can enable shareholders to maintain control throughout multiple layers of ownership while at the same time sharing the investment with other (minority) shareholders at each intermediate ownership tier. Some European countries have traditionally allowed companies to design a pyramidal structure of shareholdings which is one of the mechanisms that

reduces the liquidity constraints of large shareholders while it allows those shareholders to retain substantial voting power. Whereas pyramids of share stakes require smaller investment of capital (smaller cash flow rights), the large shareholder can still control his target company. For instance, if shareholder X owns 51% of the voting equity of firm Y that in turn owns 51% of the voting equity of firm Z, there is an uninterrupted control chain that gives shareholder X absolute majority control. Still, the cash flow rights of shareholder X are merely 26%.

Table 5. Ownership and voting power

	Control	
Ownership	Panel A: Dispersed ownership and dispersed voting power	Panel B: Dispersed ownership and concentrated voting power
	Panel C: Concentrated ownership and dispersed voting power	Panel D: Concentrated ownership and concentrated voting power

Panel A: Dispersed ownership and dispersed voting power

Where: US, UK.
Advantages: a. Portfolio diversification and liquidity
b. Takeover possibility
Disadvantages: Insufficient monitoring; free-riding problem
Agency conflicts: Management vs. shareholders

Panel B: Dispersed ownership and concentrated voting power

Where: Countries where a stakeholder can collect proxy votes and shareholder coalitions are allowed.
Advantages: a. Monitoring of management
b. Portfolio diversification and liquidity
Disadvantages: a. Violation of one-share-one-vote
b. Reduced takeover possibility
Agency conflicts: Controlling block holders vs. small shareholders

Panel C: Concentrated ownership and dispersed voting power

Where: Any company with voting right restrictions
Advantages: Protection of minority rights
Disadvantages: a. Violation of one-share-one-vote
b. Low monitoring incentives
c. Low portfolio diversification possibilities and low liquidity
d. Higher cost of capital
e. Reduced takeover possibilities
Agency conflicts: Management vs shareholders

Panel D: Concentrated ownership and concentrated voting power

Where: Continental Europe, Japan, in any country after takeover
Advantages: High monitoring incentives
Disadvantages: a. Low portfolio diversification possibilities and low liquidity
b. Reduced takeover possibilities
Agency conflicts: Controlling block holders vs small share holders

Another solution for the reduced liquidity is the issuance of dual-class voting shares to separate ownership and control. The costs of reduced liquidity for the large shareholder can be more than compensated for by the value of control, as control can allow a large shareholder to transfer resources from the company. The private benefits of control are non-transferable benefits beyond the financial return on investment. For example, if a car producer attracts a subcontractor to supply him with car seats, a large shareholding in the subcontracting company can yield an important (strategic) advantage. The large shareholder is usually allowed a seat on the board of directors and will thus receive non-public information on the firm's cost structure or on supply contracts of the competitors. The large shareholder could, for example, after obtaining such strategic information, renew negotiations about the subcontractor's price. Consequently, such transactions can lead to the creation of another kind of agency conflict, namely the oppression of minority shareholders' rights. Another example illustrates the danger of expropriation of minority shareholders: suppose that a shareholder owns 51% of the voting shares in firm A and that this shareholder also owns 100% of the equity of firm B. If firm A is a supplier of firm B, the controlling shareholder may be tempted to reduce the transfer price of goods sold to firm B. This way profits are maximised in firm B of which the shareholder has full control and owns all the cash flow rights whereas profits are minimised in firm B at the expense of the minority shareholders. Other examples of tunnelling in the context of the transition economies are given in Johnson et al. (2000).

A third common way to accumulate control with limited investment is the use of proxy votes. An example of proxy voting can be observed in Germany where banks use the voting rights deposited with them by shareholders. This is conditional on the bank announcing how it will vote on specific propositions and on a written confirmation by the depositing shareholders allowing proxy voting. Another example of proxy voting takes place in the US when the management makes propositions for the annual meeting and solicits proxy votes from the shareholders. A third mechanism to maintain control with a limited investment is by issuing dual-class shares and holding the voting shares. Dual-class shares are frequently used in Scandinavia, France, Spain, Italy and the US, but are not present in the UK and were recently abolished in Germany.

They are commonly employed by European firms, but with large differences across EU member states. Faccio and Lang (2002) document 5,232 firms in 13 Western European countries. For instance, in Finland, Italy, Denmark, Switzerland and Sweden, the proportion of firms with outstanding dual-class stocks ranges from around 35% to 65%. For Norway, Germany, UK, Austria and Ireland, the range varies from 13% to 24%. In Portugal, Spain and France the proportions are almost negligible (see Table 6).

The move towards firms being capitalised with dual and multiple classes of common stock is caused by the development of an integrated market for corporate control, which exposed even the largest firms to hostile bids. In the US, dual-class shares have become an increasingly important concern to investors since the 1980s, as stock exchanges have liberalised their restrictive policy on multiple- and dual-class shares (Gordon, 1992). Dual-class shares provide equity finance without ceding control rights. In a dual-class regime, one class (henceforth B) has less voting rights than the other class of shares (henceforth A).

Table 6. Dual-class shares in Europe

Country	No. of firms	No. with dual class	in %	Premium	Period
Austria	99	23	23.23		
Belgium	130	0	0.00		
Denmark	210	70	33.33	20-35%	1985-91
Finland	129	47	36.43		
France	607	16	2.64		
Germany	704	124	17.61	17.2% (-5%-35%)	1956-98
Ireland	69	16	23.19		
Italy	208	86	41.35	82%	1987-90
Norway	155	20	12.90		
Portugal	87	0	0.00		
Spain	632	1	0.16		
Sweden	334	185	55.39		
Switzerland	214	109	50.93		
UK	1953	467	23.91		
Total	5531	1164	21.05		

Sources: Faccio and Lang (2002) and Bennedsen and Nielsen (2002).

The range of variation across Europe is considerable with regard to the specification of dual-class shares. For example, the voting rights of B shares in Sweden are typically 1/10 of the voting rights of A shares, while in other countries the B class shareholders carry no voting rights. In principle, 1/10 voting shares are the same as non-voting shares because the B class has to abandon a part of their voting rights proportional to the risk-bearing capital they represent. The scale of the surrender does not play a role in an economic analysis. Moreover, in Germany, but also in other countries, there exist preferred stocks (*Vorzugsaktien*). These are risk-bearing capital in the sense of non-voting stock, but they also possess dividend rights. Finally we find also multiple-voting stocks. This is the case where one class (A) has additional voting rights compared to the other (B). A special case of a multiple-voting stock is a so-called 'golden share' where one or more shareholders get a veto right for certain (well) defined situations. Against this background, it surprising that (at least) some of the European authorities do explicitly discriminate.

Table 7 displays the legal restrictions on dual-class shares, the number of firms employing them for each country, and the average minimum percentage of stock needed to control 20% of the voting rights.

We can see that Sweden and Finland, which have been shown to impose a lower limit on voting rights of shares, evidence higher concentrations of ownership than jurisdictions where there are no limits on voting rights. In contrast, the striking absence of firms using dual-class shares in some jurisdictions is a direct consequence of the persistence of the one-share/one-vote rule.

Meanwhile, corporate governance scholars have attempted to measure the size of private benefits of control. Beginning with Barclay and Holderness (1989), studies of private benefits have estimated the magnitude of private benefits empirically by measuring the privately negotiated acquisition of control blocks in publicly traded companies and the market price of a share after the announcement, corrected for bargaining power. Based on this analysis, Dyck and Zingales (2002) propose to measure

the private benefits of control in 39 countries based on 412 control transactions for the period 1990-2000. They find that the value of control ranges between -4% and +65% with an average of 14%. In some European countries, the size of private benefits appears to be very large. For example, the mean premium in Austria, Italy and Portugal was 38%, 37% and 20% respectively. In contrast, they find that most other European countries show a mean premium below 10%.

Table 7. Current regulation in Europe[1]

Country	Details	No. of firms	Own 20%[2]	Dual-class shares (%)[3]
One-share/one-vote				
Belgium		130	20.00	0.00
Norway	Exception by government approval	155	19.05	13.16/12.90
Proportion on non-voting (and limited voting) stocks capped				
France	< 25% of stock capital	607	19.93	2.64
Germany	< 50% of stock capital	704	18.83	17.61
Italy	< 50% of stock capital	208	18.38	41.35
Spain	< 50% of stock capital	632	20.00	0.16
Portugal	< 50% of stock capital	87	20.00	0.00
Minimum voting ratio				
Denmark	Minimum ratio:10%	102	n/a	51
Finland	Minimum ratio:10%	129	15.42	37.60/36.43
Sweden	Minimum ratio:10%	245	9.83	66.07
UK	Minimum voting rights[4]	1953	19.14	23.91
Unrestricted				
Austria		99	18.96	23,23
Ireland		69	18.91	28.07/23.19
Switzerland		214	15.26	51.17/50.39
Luxembourg		n/a	n/a	n/a
Netherlands	Complex	n/a	n/a	n/a
Greece		n/a	n/a	n/a
Total		5334	18.74 (av.)	19.91 (av.)

[1] Legal restrictions on issuing dual-class shares.

[2] 'Own 20%' is the average minimum percent of the book value of equity to control 20% of votes.

[3] 'Dual-class shares' is the percentage of firms with outstanding dual-class shares.

[4] In the UK, non-voting shares have been outlawed since 1968, but firms are free to issue 'preference stocks' given minimum rights are provided. This includes voting 1) if the dividend is in arrears, 2) if the share capital should be reduced or the company should be dismantled or 3) if the class rights will be affected.

Sources: Faccio and Lang (2002); Bennedsen and Nielsen (2002); and Rose (2002).

In this report, we also employed the Barclay and Holderness method to examine block transactions in Europe and US. We find that the value of control ranges between 1% and 58%, with an average 13% (Table 8).

Table 8. Block premiums as a percent of firm equity

Country	Mean	Median	Standard deviation	Min	Max	No. of observations	No. of positive obs
Argentina	0.27	0.12	0.26	0.05	0.66	5	5
Australia	0.02	0.01	0.04	-0.03	0.11	13	9
Austria	0.38	0.38	0.19	0.25	0.52	2	2
Brazil	0.65	0.49	0.83	0.06	2.99	11	11
Canada	0.01	0.01	0.04	-0.02	0.06	4	2
Chile	0.15	0.12	0.18	-0.08	0.51	9	8
Colombia	0.27	0.15	0.34	0.06	0.87	5	5
Czech Republic	0.58	0.35	0.80	0.01	2.17	6	6
Denmark	0.08	0.04	0.11	-0.01	0.26	5	3
Egypt	0.04	0.04	0.05	0.01	0.07	2	2
Finland	0.02	0.01	0.06	-0.07	0.13	14	9
France	0.02	0.01	0.10	-0.10	0.17	5	3
Germany	0.10	0.10	0.13	-0.24	0.32	18	15
Hong Kong	0.01	0.03	0.05	-0.12	0.05	9	7
Indonesia	0.07	0.07	0.03	0.05	0.09	2	2
Israel	0.27	0.21	0.32	-0.01	0.89	9	8
Italy	0.37	0.16	0.57	-0.09	1.64	8	7
Japan	-0.04	-0.01	0.09	-0.34	0.09	21	5
Malaysia	0.07	0.05	0.10	-0.08	0.39	41	31
Mexico	0.34	0.47	0.35	-0.04	0.77	5	4
Netherlands	0.02	0.03	0.05	-0.07	0.06	5	4
New Zealand	0.03	0.03	0.09	-0.17	0.18	19	14
Norway	0.01	0.01	0.05	-0.05	0.13	14	9
Peru	0.14	0.17	0.11	0.03	0.23	3	3
Philippines	0.13	0.08	0.32	-0.40	0.82	15	11
Poland	0.11	0.08	0.11	0.02	0.28	5	5
Portugal	0.20	0.20	0.14	0.11	0.30	2	2
Singapore	0.03	0.03	0.03	-0.01	0.06	4	3
South Africa	0.02	0.00	0.03	0.00	0.07	4	2
South Korea	0.16	0.17	0.07	0.04	0.22	6	6
Spain	0.04	0.02	0.06	-0.03	0.13	5	4
Sweden	0.06	0.02	0.08	-0.01	0.22	13	12
Switzerland	0.06	0.07	0.04	0.01	0.15	8	8
Taiwan	0.00	0.00	0.01	-0.01	0.00	3	2
Thailand	0.12	0.07	0.19	-0.08	0.64	12	11
Turkey	0.30	0.09	0.55	-0.03	1.41	6	5
United Kingdom	0.02	0.01	0.05	-0.06	0.17	43	23
United States	0.02	0.02	0.10	-0.20	0.40	47	28
Venezuela	0.27	0.28	0.21	0.04	0.47	4	4
Average/number	0.14	0.11	0.18	-0.04	0.48	412	300
Only Europe and the US:							
Average/number	0.13	0.04	0.17	-0.03	0.44	200	140

Note: This table presents descriptive statistics by country on the block premiums in the 412 control block transactions we study. The block premium is computed by taking the difference between the price per share paid for the control block and the exchange price two days after the announcement of the control transaction, dividing it by the exchange price two days after the announcement and multiplying the ratio by the proportion of cash flow rights represented in the controlling block.

Source: Dyck and Zingales (2002).

Economists studying private benefits of control warn that estimating the value of the control premium is complicated. In trying to explain the size of private benefits, economists have argued that the control premium depends on a number of factors, including the competition in the market for corporate control, the size of the block sold, the distribution of shares in the target firm, the inequality of voting power, the nationality of the buyer and the financial condition of the firm involved (Berglöf and Burkart 2002; Dyck and Zingales 2002). Almost invariably, the existence of large private benefits of control suggests that large shareholders may be able to obtain a large share of the rents. The control premium is lower in Anglo-American market-based corporate governance systems, which have widely dispersed ownership structures and provide a high level of legal protection for minority shareholders. Finally, the factors explaining the differences in legal enforcement in the Dyck and Zingales study are tax compliance and product market competition.

Goergen and Renneboog (2003a) take a different approach to analyse why the levels of control are so different in two countries with highly varying corporate governance regimes, Germany (a bank and block-holder based governance system) and the UK (a market-based regime). A first reason for shareholders to hold larger voting stakes in German firms is found in the differences in the regulatory and legal environment. A detailed analysis of the regulation of the German and UK stock exchanges, of the rules on minority shareholder protection, of informational transparency and of the takeover codes shows that there is lower shareholder protection in Germany. The voting practice at annual meetings, the composition of the board of directors and their fiduciary duties further reinforce this relative weakness of shareholder rights in Germany. As a consequence, control is more valuable to shareholders of German firms either to avoid expropriation of their investments or to take advantage of the higher levels of private benefits. Furthermore, holding large control stakes is less expensive in Germany relative to the UK because ownership pyramids, the possibility of issuing non-voting stock and the possibility to nominate one's representatives to the board of directors ensure that control can be maintained with relatively low levels of cash flow rights.

Although the legal environment predicts stronger levels of control in Germany, it does not explain how the difference in control concentration comes about. Both UK and German firms are floated on the stock exchange with high levels of initial control, and this raises the question as to what triggers subsequent changes in control. To answer this question, Goergen and Renneboog (2003a) investigate the economic factors that determine control retention by large initial shareholders, dissipation of control among many small shareholders, and control transfers whereby they distinguish widely held and concentrated bidders. The paper uses a unique database of IPOs of which the control structure is tracked through time. They find that not only do the initial shareholders in the average German company own much larger stakes than their UK counterparts, but they also lose majority control only six years after the public offering. In contrast, initial owners in UK companies lose majority control as early as two years after going public.

Goergen and Renneboog (2003a) find strong evidence that corporate characteristics lead to differences in control evolution across companies within a country but also between the UK and German firms. Their Tobit models, which estimate the percentage of control held by the initial and new large shareholders and the size of the free float six years

subsequent to the flotation, show that corporate size is an important determinant of control concentration in the UK but not in Germany. Large UK companies evolve towards a more widely held equity structure whereas in large German firms new shareholders hold significantly larger voting stakes. The reason is that wealth constraints become binding for UK shareholders, whereas German shareholders can avoid this effect by leveraging control via pyramids.

If the founder of a German firm is still a major shareholder at the initial public offering and if there are non-voting shares outstanding, control is likely to remain tight in the hands of the initial shareholders. This is not surprising as founding families often extract (non-pecuniary) private benefits of control and non-voting shares enable them to raise additional equity capital whilst maintaining control. Whereas Goergen and Renneboog (2003a) do not find any impact of growth on the control concentration of UK firms, strong growth in German firms leads to the initial shareholders transferring control to new large shareholders.

Finally, Goergen and Renneboog (2003a) estimate multinomial logit models which predict the occurrence of different states of control (initial shareholders retain control, control is diluted, control is transferred to a concentrated shareholder or to a widely-held firm). They show that specific corporate characteristics lead to different 'equilibrium' control states six years after the flotation. For the UK, the probability of a transfer of control to a concentrated shareholder increases when a company is risky, small and a poor performer. A UK firm is more likely to be taken over by a widely held firm, if it is large, fast-growing and profitable. So, for the UK, poor performance and high risk necessitate a high level of control and tight monitoring by a concentrated shareholder. High growth and profitability attract widely held companies whose management may follow an 'empire-building' acquisition programme. The authors also document that high growth also leads to more diffuse control, which in turn is less likely when the founding family is still involved in the company. Founding families may be less inclined to dilute their stake in order to retain private benefits of control. When German firms are profitable and risky, control is more likely to be acquired by a concentrated shareholder, but growth and low profitability increase the likelihood of being acquired by a widely held firm.

5. Takeovers in the European Union and the US: Evolution

The clustering of mergers and acquisitions through time is a striking phenomenon. The first European merger wave started approximately in 1880 and ended in 1904. It was fuelled by the industrialisation started by the discovery of the steam engine. The prime incentive for these mostly horizontal mergers was the creation of monopolies. The introduction of anti-trust legislation played an important role in the second merger wave, which started in 1919 and continued throughout the 1920s. The old monopolies were broken up and mergers and acquisitions were used to achieve vertical integration. The third merger wave started in the 1950s, but reached its peak only in the mid-1960s. The focus turned towards diversification and the development of large conglomerates to face global markets. The development of new financial instruments and markets (e.g. the junk bond market) facilitated the financing of acquisitions and led to the fourth wave (1983-89), which was fuelled by technological progress in biochemistry and electronics. The fifth M&A wave emerged in the early 1990s (1993-2000) and went hand-in-hand

with a long economic boom period, stock exchange development and the growth in the internet and telecommunications industries. In 2001, the collapse of consumer confidence in these industries as well as the overcapacity in the traditional sectors caused an abrupt reduction in merger activity.

Over 1993, the total dollar value paid for target firms in the US and Europe doubled after four consecutive years of reduction in M&A activity. Tables 9 and 10 exhibit a sharp rise as of 1996: the total value of US and European acquisitions rose to $840 million (with Europe accounting for 45%).[5] In the following years, the M&A wave gained even more strength with a value of $119 billion in 1997 (44% of which was realised in Europe), $196 billion in 1998 (42% in Europe) and $257 billion in 1999 (49% in Europe). The year 1999 was not only remarkable, because the European M&A market was now almost as large as the US market or because 12% of the total value could be accounted for by deals in excess of $100 billion, but also because an exceptionally high number of hostile takeovers took place in Europe. There were 369 hostile bids in Europe in 1999 compared to only 14 in 1996, 7 in 1997, 5 in 1998 and 35 in 2000.[6] The market for corporate control briefly sustained its momentum mainly as a result of European M&A activity. In 2000, the total value of all M&A deals amounted to $269 billion (53% in Europe). The stock market collapse of 2000 eroded shareholder confidence and brought about a significant decline in the M&A activity by 41% to $158 billion. The year 2002 is expected to have known a further collapse of the takeover market by another 50%.

Table 9. US acquisitions and divestitures from 1984 to October 2002

	Acquisitions		Divestitures		Divest./acquisition (in value)
Year	No. of deals	Value ($bn)	No. of deals	Value ($bn)	(%)
1985	1,713	148	767	50	34
1986	2,523	221	1,117	83	38
1987	2,517	211	1,014	77	36
1988	3,011	291	1,310	108	37
1989	3,828	324	1,660	89	27
1990	4,324	207	1,942	86	42
1991	3,642	141	1,829	54	38
1992	3,871	126	1,771	55	44
1993	4,436	179	2,052	77	43
1994	5,292	281	2,188	104	37
1995	6,706	391	2,598	143	37
1996	7,811	573	2,864	199	35
1997	9,059	784	2,970	219	28
1998	10,638	1,373	3,108	305	22
1999	9,546	1,438	2,841	289	20
2000	9,183	1,786	2,648	368	21
2001	6,224	1,143	2,331	245	21

Sources: Various annual almanacs of mergers & acquisitions; and Sudarsanam (2003).

[5] The value total value of M&As excludes the acquisitions related to divestitures.

[6] As reported in an M&A report by Morgan Stanley using Thomson Financial Securities Data, April 2001.

Table 10. EU acquisitions and divestitures from 1984 to October 2002

	Acquisitions		Divestitures		Divest./Acquis. (in value)
Year	No. of deals	Value ($bn)	No. of deals	Value ($bn)	(%)
1984	41	1	7	0	2
1985	256	14	66	2	15
1986	553	40	142	16	40
1987	1,209	64	326	17	27
1988	2,356	108	602	36	33
1989	3,261	164	814	58	35
1990	3,407	175	1,228	73	42
1991	6,503	148	2,298	57	39
1992	6,056	159	2,267	59	37
1993	5,287	168	2,072	85	51
1994	5,902	156	2,063	63	41
1995	6,891	243	2,321	81	33
1996	6,281	267	2,274	98	37
1997	7,173	402	2,561	154	38
1998	7,744	584	2,421	173	30
1999	9,301	1,129	2,828	246	22
2000	10,405	899	3,016	313	35
2001	7,855	439	2,562	167	38
2002	4,709	224	1,557	117	52

Sources: Thomson Financial SDC database; and Sudarsanam (2003).

Table 11. Distribution of M&A activity and GDP between EU member states 1991-2001

Member state	Share of EU M&A activity (%)	Share of EU GDP (%)
Belgium	2.8	3.2
Denmark	2.6	2.1
Germany	16.3	28.2
Greece	1.1	1.4
Spain	5.0	7.0
France	13.5	18.1
Ireland	1.7	0.9
Italy	6.2	12.6
Luxembourg	0.5	0.2
Netherlands	6.5	4.9
Austria	2.1	2.7
Portugal	1.2	1.3
Finland	3.9	1.6
Sweden	5.3	2.8
United Kingdom	31.4	13.2

Note: In calculating this table, cross-border intra-Community operations are counted twice, once for the bidder country and once for the target country. Percentage for EU may not add up to 100 because of rounding.

Source: Directorate General for Economic and Financial Affairs, European Commission, *European Economy*, Supplement A, Economic Trends, No. 12, 2001.

Table 11 shows that the most active M&A market consists of the UK which represented 31.4% of the EU market for corporate control but only made up 13.2% of EU GDP in 2001. In contrast, Germany (28.2% of EU GDP) only accounted for 16.3% of the M&A

market. The third M&A market of the European Union consisted of France with 13.5%. Whereas most takeovers are domestic, the number and percentage of cross-border takeovers have risen substantially, especially the number of foreign non-EU acquisitions (mostly by a US bidder or of a US target) (see Table 12). The percentage of domestic acquisitions within the member states of the EU decreased from 65.1% in 1991 to 56.4% in 1999, while the percentage of cross-border acquisitions remained relatively stable at about 15% of all M&A activity involving firms located in the EU. The percentage of EU firms taken over by non-EU corporations remained relatively stable over the 1990s, but the relative activity of EU firms in cross-border acquisitions outside the EU more than doubled from 8.1% in 1991 to 17.4% in 1999.

Table 12. Evolution of national, community and international M&A operations in the EU (% of all M&A transactions)

Year	National	Community	International EU-target	International EU-bidder	Total
1991	65.1	14.0	12.8	8.1	100
1992	67.9	12.9	12.2	7.1	100
1993	63.5	12.5	14.9	9.1	100
1994	62.7	13.6	13.5	10.2	100
1995	61.0	13.5	12.7	12.7	100
1996	57.9	13.5	14.8	13.8	100
1997	56.8	14.3	15.6	13.3	100
1998	55.0	14.5	15.5	14.9	100
1999	56.5	15.0	11.2	17.4	100

Source: Directorate General for Economic and Financial Affairs, European Commission, *European Economy*, Supplement A, Economic Trends, Table 9, 2000.

At the height of the fifth takeover wave, the total value of deals in the EU amounted to 12% of cumulative GDP (in 1999) as a consequence of an increase in the number of deals and individual deal size. The total value in the US even went to 16% of GDP (in 1998). Since then, M&A levels have fallen to more normal percentages of between 1-3% (see Figure 3). As depicted in Figure 4, the collapse of the stock market in 2000 caused the average size of takeover deals in 2002 to fall to 40% of the pre-collapse levels in both the EU and US.

Over the past five years, the means of payment in takeover bids consisted of cash in 47% of the EU offers and 37% of US bids (see Figures 7 and 8). All-equity bids were made in 10% and 24% in EU and US takeover cases respectively. The remainder of the bids consisted of a combination of cash, equity and debt. Not only have the number and average size of the takeover deals declined since 2000, but the financial composition of the takeover bids also changed. For both the EU and the US, the relative importance of cash deals increased by about 50% (see Figure 5). The declining market capitalisations of bidding firms and increased risk-aversion on the part of the target shareholders have reduced the current relative importance of all-equity bids to one-third of its level in 2000.

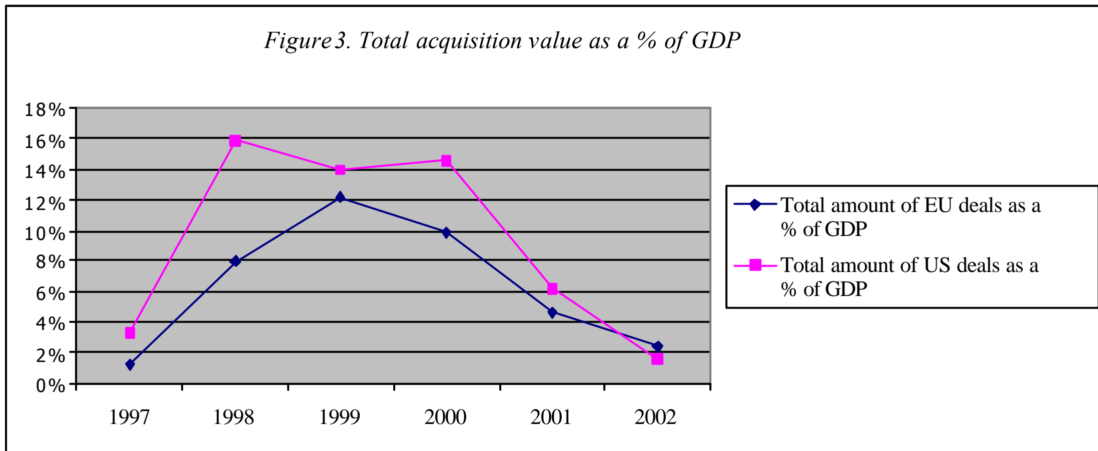
Figure 3. Total acquisition value as a % of GDP
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
1997
1998
1999
2000
2001
2002
Total amount of EU deals as a % of GDP
Total amount of US deals as a % of GDP

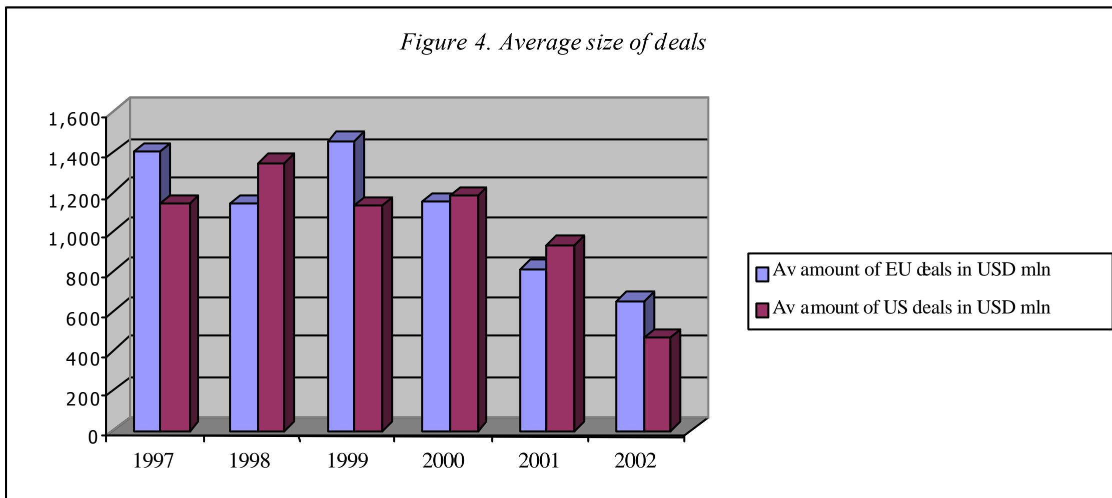
Figure 4. Average size of deals
1,600
1,400
1,200
1,000
800
600
400
200
0
1997
1998
1999
2000
2001
2002
Av amount of EU deals in USD mln
Av amount of US deals in USD mln

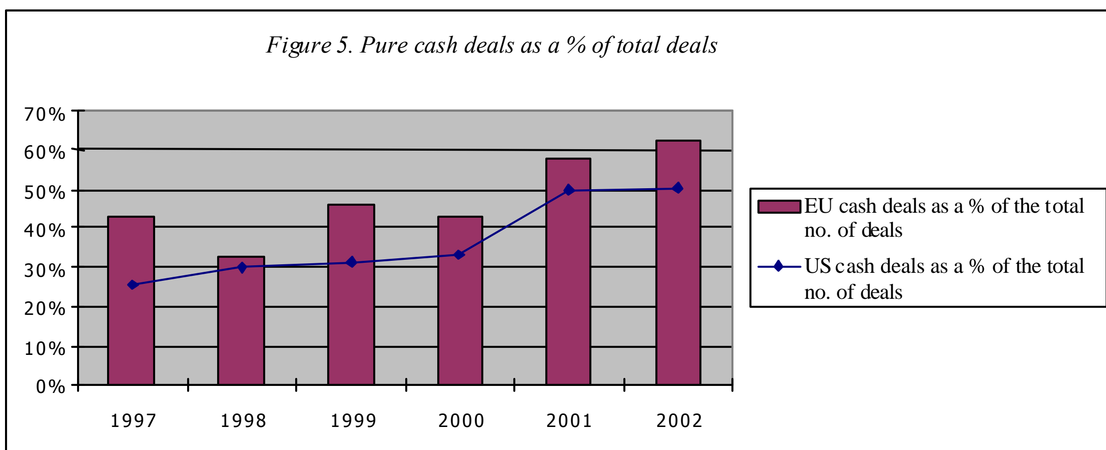
Figure 5. Pure cash deals as a % of total deals
70%
60%
50%
40%
30%
20%
10%
0%
1997
1998
1999
2000
2001
2002
EU cash deals as a % of the total no. of deals
US cash deals as a % of the total no. of deals

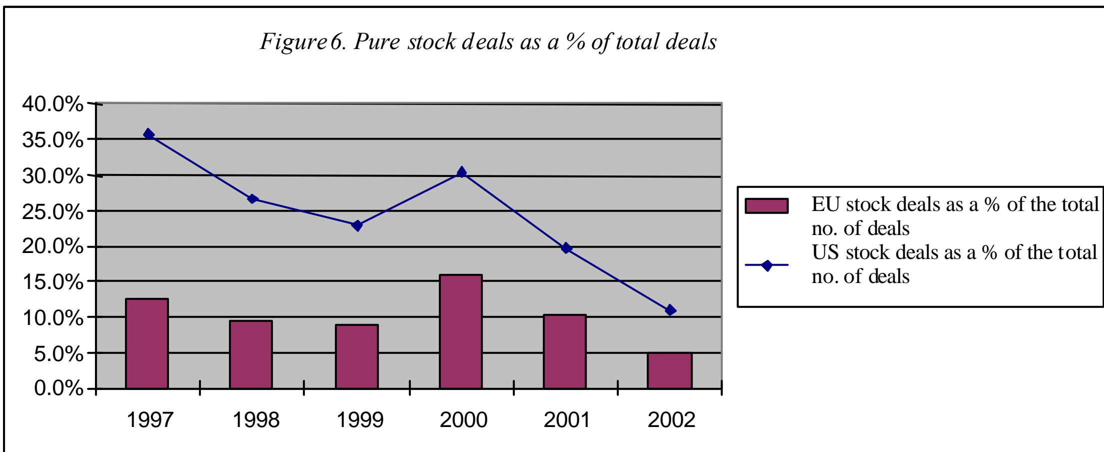
Figure 6. Pure stock deals as a % of total deals
40.0%
35.0%
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
1997
1998
1999
2000
2001
2002
EU stock deals as a % of the total no. of deals
US stock deals as a % of the total no. of deals

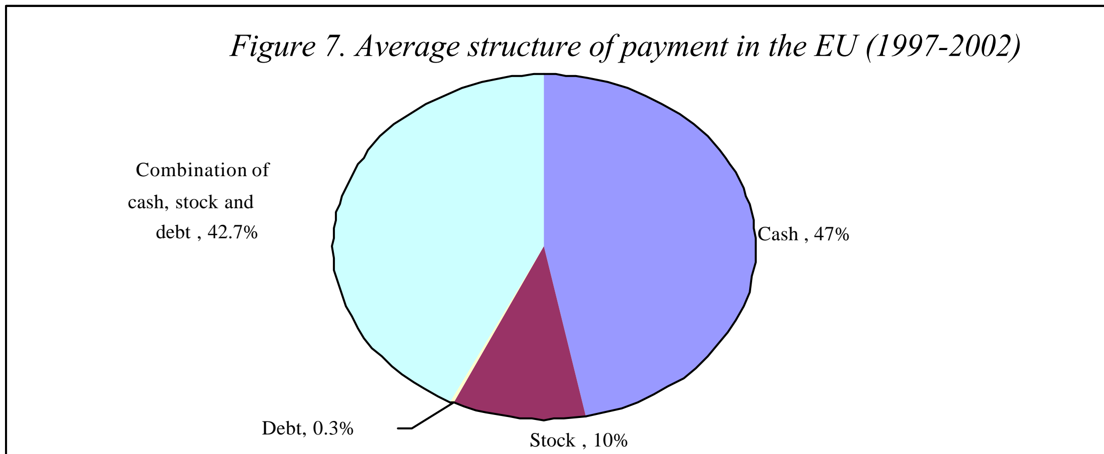
Figure 7. Average structure of payment in the EU (1997-2002)
Combination of cash, stock and debt , 42.7%
Cash , 47%
Debt, 0.3%
Stock , 10%

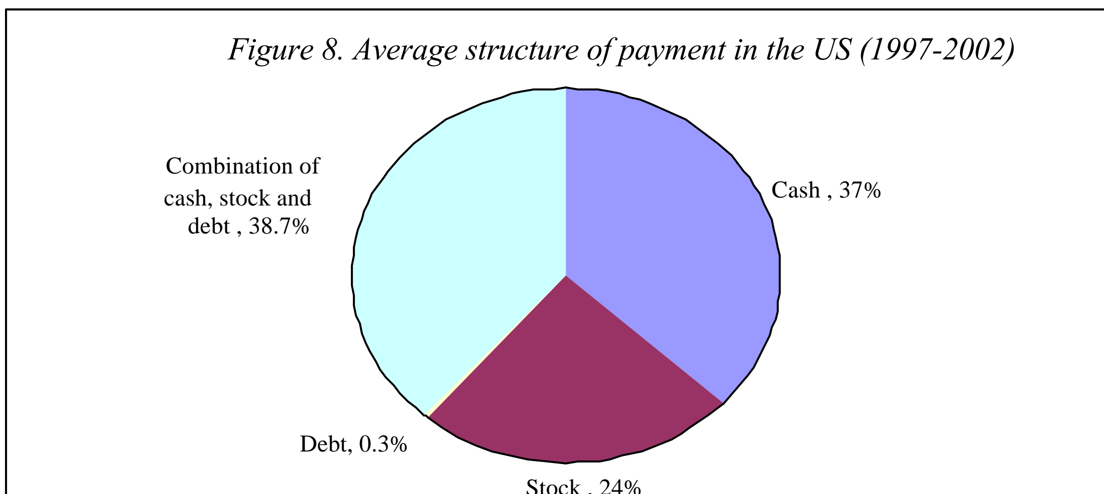
Figure 8. Average structure of payment in the US (1997-2002)
Combination of cash, stock and debt , 38.7%
Cash , 37%
Debt, 0.3%
Stock , 24%

Part II

6. The Determinants of Bidder and Target Returns in the Economic Literature

The literature on the wealth effect of M&A announcements for target shareholders is unanimous: these shareholders receive an average premium within the 15 to 30% range over and above the pre-announcement share price (Table 13). From the 1960s to the 1980s, Jarrell and Poulsen (1989), Servaes (1991) and Kaplan and Weisbach (1992), for instance, report average US target share price returns of 29% for 1963-86, 24% for 1972-87 and 27% for 1971-82, respectively. In the 1990s, the US abnormal announcement returns remained at a similar level of 21% (Mulherin and Boone, 2000). In contrast, there is little consensus about the announcement wealth effects for the bidding firms. About half of the studies report small negative returns for the acquirers (see e.g. Walker, 2000; Mitchell and Stafford, 2000; Sirrower, 1997; and Healy, Palepu and Ruback, 1992), whereas the other half finds zero or small positive abnormal returns (see e.g. Eckbo and Thorburn, 2000; Maquiera et al., 1998; Schwert, 2000; and Loderer and Martin, 1990). Considering that the average target is much smaller than the average acquirer, the combined net economic gain at announcement is positive, albeit small.

The findings for the UK are similar to those for the US although the target shareholders' abnormal returns are somewhat higher (Table 13). For the whole of Europe, Goergen and Renneboog (2003b) show that the announcement effect of a take-over, including the price run-up which starts 40 trading days prior to the first public announcement, cumulates to an abnormal return of 21.3% over and above the expected CAPM-return. The bidder returns are positive but close to zero.

Previous research on cross-border M&A activity is largely confined to studies that involve US firms as targets or bidders. Similar to domestic acquisitions, the shareholders of US target firms can pocket large positive abnormal returns (see e.g. Harris and Ravenscraft, 1991; Cebenoyan et al., 1992; and Cheng and Chan, 1995) in cross-border bids. Two studies analyse cross-border acquisitions between US and UK companies: Conn and Connell (1990) for the period 1971-80 and Feils (1993) for the period 1980-90. Both studies conclude that the wealth effect for US target firms is substantially larger than for UK firms (40% vs 18% in Conn and Connell and 26% vs 16% in Feils). Danbolt (2002) finds no statistical difference between short-run abnormal returns for UK targets of domestic mergers and acquisitions (18.46%) and those of cross-border takeovers (19.68%). Both Wansley et al. (1983) and Dewenter (1995) suggest that the cross-border returns-effect for target US firms results from differences in the bid characteristics of domestic and cross-border acquisitions rather than from fundamental differences in the level of abnormal returns. Such a conclusion is also reached for UK target firms by Danbolt (2002): the target cross-border effect appears to be attributable to the method of payment, bid outcome and industrial sector.

Table 13. Abnormal returns to shareholders surrounding successful takeover announcements

Study; sample period; sample size	Country	Event window (around announcement)	Benchmark return model	Target abnormal return (%)	Bidder abnormal return (%)
Jensen & Ruback (1983) (summary of 7 previous studies) 1958-81; 17 to 161	US	20 to 60 days	Market-adjusted	29	4
Jarrell & Poulsen (1989) 1963-86; 526	US	31 days	Not reported	29	1
Jarrell, Brickley & Netter (1988) 1960-85; 405	US	31 days	Not reported		2
Magenheim & Mueller (1988) 1976-81; 78	US	1 month	Market		1
Bradley, Desai & Kim (1988) 1963-84; 236	US	11 days	Market	32	1
Loderer & Martin (1990) 1966-84; 274	US	6 days	Market		1
Schwert (1996) 1975-81; 1814	US	42 days before 126 days after	Market	16 20	
Jensen & Ruback (1983) (summary of 7 previous studies) 1962-79; 60 to 256	US (tender)	1 month	Market	16	1
Loderer & Martin (1990) 1966-84; 1135	US (tender)	6 days	Market	Not reported	1
Schwert (1996) 1975-81; 959	US (tender)	42 days before 126 days after	Market	12 5	
Firth (1980) 1969-75; 486	UK	1 month	Market	28	-6
Franks & Harris (1989) 1955-85; 1445	UK	1 month	Market, market-adjusted & CAPM	22	0
Limmack (1991) 1977-86; 462	UK	Bid period (3 months)	Market	31	-0
Sudarsanam, Holl & Salami (1996) 1980-90; 429	UK	-20 to +40 days	Market	29	-4
Higson & Elliott (1998)	UK	Bid period (3 months)	Size	38	0
Sudarsanam & Mahate (2003) 1983-95; 519	UK	-1 to +40 days	Size, market-adjusted, book to market		-1 to –2
Baker & Limmack (2002) 1977-90; 595	UK	1 month	8 methods		0
Bergstrom, Hogfeldt & Hogholm (1993) 1980-92; 94 targets, 149 bidders (tender offers)	Sweden	11 days	Market	17	0
Doukas & Holmen (2000) 1980-95; 93 tender offers	Sweden	11 days	Market		1
Van Hulle, Vermaelen & de Wouters (1991) 63 tender offers	Belgium	6 weeks	Market	38	-1
Van Hulle, Vermaelen & de Wouters (1991); 76 acquirers & 48 acquired	Belgium	3 months	Market	6	-1

Eckbo & Langohr (1989) 1966-82; 90 targets & 52 acquirers in public tender offers	France	16 weeks	Market	14	-3
Goergen & Renneboog (2003b) 1993-2000: 136 target and 142 bidding firms	Europe	1 day 40 days prior + event day	CAPM	9.0 (1 day) 23.1 (40 days)	0.7 (1day) 0.4 (40 days)

Sources: Sudarsanam (2003) and Goergen and Renneboog (2003b).

Table 14. Abnormal returns to acquirer and bidder shareholders in cross-border acquisitions

Study; sample period; sample size	Acquirer country - (target country)	Benchmark abnormal return (%) (days)	Significant factors (effect on returns)
Cakici, Hessel & Tandon (1996) 1983-92; 195	UK, GER, FR, NL, SWD, SWZ, IT, JP, AUS, CND – (USA)	2 (21 days) (market model)	Only AUS, JP, NL and UK (+) No tax effect
Eun, Kolodny & Scheraga (1996) 1979-90; 103	AUS, CND, UK, FR, HK, JP, NL, NZ, SWD, SWZ, GER, OT – (USA)	-1.2 (11 days) (mean adjusted)	JP & CND acquirers (+); UK acquirers (-); Target's R&D Strength (+)
Kang (1993) 1975-88; 119	JP – (USA)	0.59 (2 days)	Bank debt (+); strong yen (+) No tax effect
Markides & Ittner (1994) 1975-88; 276	US – (CND, UK, continental Europe, Pacific)	0.54 (5)	Strong $ (+); advertising intensity (+); oligopoly (+); No country effect
Cakici, Hessel & Tandon (1996) 1983-92; 195	US – (UK, GER, FR, NL, SWD, SWZ, IT, JP, AUS, CND)	0 (21 days)	
Danbolt (1995) 1986-91; 71	As above, Norway, US – (UK)	–10 (6 months post-acquisition) (market model)	
Conn & Connell (1990) 1971-80; 35	US - (UK)	-2.5 (6 months post-acquisition)	
Goergen & Renneboog (2003b) 1993-2000; 56	Europe (Europe)	2.4 (1 day) 1.5 (40 days)	cash payment (+); status of bid (hostility) (+);

Sources: Sudarsanam (2003) and Goergen and Renneboog (2003b).

The M&A literature has discovered a variety of profitability drivers. First, the announcement of tender offers and hostile takeovers generates higher target as well as bidder returns than the announcement of friendly mergers or acquisitions (see e.g. Gregory, 1997; Loughran and Vijh, 1997; and Lang et al., 1989). Second, when the bidding management owns large equity stakes, bidding firms obtain higher returns (see e.g. Healy et al., 1997). This suggests that managers are more likely to undertake value-destroying mergers, if they do not own equity in their firm. Third, all-cash bids generate higher target and bidder returns than stock-for-stock acquisitions (see e.g. Yook, 2000;

Franks and Harris, 1989; Franks et al., 1988; and Huang and Walking, 1989). The announcement that the takeover will be paid with equity may signal to the market that the bidding managers believe that their firms' shares are overpriced. This is in line with the fact that managers schedule the issue of shares to occur at the high point of the stock-market cycle. Fourth, acquiring firms with excess liquidities destroy value by overbidding. Several papers show evidence that free cash flow (Jensen, 1986) is frequently used for managerial empire-building purposes (see e.g. Servaes, 1991; and Lang et al., 1991). Fifth, corporate diversification strategies destroy value (Maquiera et al., 1998; and Berger and Ofek, 1995). This confirms that companies should not attempt to do what investors can do better themselves, i.e. create a diversified portfolio. Sixth, the acquisition of value-companies leads to higher bidder and target returns. Rau and Vermaelen (1998) show that the acquisition of firms with low market-to-book ratios generates high returns (of about 12% on average) to the shareholders of the bidding firm whereas the acquisition of glamour firms (with high market-to-book ratios) leads to substantial negative returns.[7]

The main motive for mergers and acquisitions is the value creation resulting from synergies. These synergies are called operating synergies if there are economies of scale or scope, and informational synergies if the combined value of the assets of the two firms is higher than the value the stock market attributes to the assets. For example, informational synergies consist of the creation of an internal capital market: slack-rich firms with poor investment possibilities acquire slack-poor firms with outstanding growth opportunities.[8] Informational synergies can also consist of minimising transaction costs or bankruptcy costs. However, Warner (1977) shows that the reduction in direct bankruptcy costs (due to less than perfectly correlated earnings of the bidder firm and the target firm) is small. In Anglo-American markets, the role of hostile takeovers as a disciplinary force to remove poorly performing management is also often emphasised. This market for corporate control seems to be more active in the US (Morck et al., 1988; Bhide, 1989; and Martin and McConnell, 1991) than in the UK (Franks, Mayer and Renneboog, 2001).

7. What determines the premiums in European takeover bids? Empirical Evidence of the Composition of the Bid, the Bidder and Target Firms[9]

7.1 Aim

We investigate the impact of the composition of the takeover bid, the characteristics of the bidder and target firms and of the regulation of the different European countries on the premiums paid for target firms. In particular, we examine whether the differences in corporate law, particularly in shareholder protection, influence the price paid for shares.

[7] For an excellent overview of post-merger performance and of the motives for mergers and tender offers, see Agrawal and Jaffe (2000).

[8] Still, the empirical evidence investigating the creation of internal capital markets shows that diversified firms do not rely significantly less on the outside capital market than do non-diversified firms (Comment and Jarrell, 1995).

[9] This section was written by Luc Renneboog and is based on his dataset.

7.2 Data and methodology

Data on European acquisitions – involving both a European bidder and target – are collected from the 'foreign deals' section of the monthly *Mergers & Acquisitions Report* for the period 1993-2000, a period that coincides with the fifth takeover wave. To be included in our sample, we require that either the bidder or the target (or both) are listed on a European stock exchange, and that the announcement dates are available. We restrict the sample to large acquisitions only, with a deal value of at least $100 million. We also used information from the Financial Times (FT) to check the data quality from the *Mergers & Acquisitions Report*, and to collect missing information such as missing announcement dates. The resulting sample consists of 228 merger or acquisition announcements. Cases where a bid is made for only part of a firm (a divestiture) are also included in the sample. In these cases, the target share price reaction is that of the divesting firm.

We adopt the distinction between mergers and acquisitions made by the FT and the *Mergers & Acquisitions Report*. Both sources describe a merger as a transaction between two parties of roughly equal size, whereas in a (friendly) acquisition, the larger party takes over the smaller one. An acquisition (attempt) is classified as hostile if the board of directors of the potential target rejects the offer for whatever reason. Hostility may result, among other reasons, from a bargaining strategy to extract a higher premium for the target shareholders (Schwert, 2000) or from the target's directors' viewpoint that the proposed plan is incompatible with the target's strategy. We also consider all acquisitions with multiple bidders to be hostile and report these cases separately. Lack of share price and/or accounting information reduced the sample to 187 offer announcements in 18 European countries. Out of these 187 bids, 142 bidders and 134 targets are listed. The final sample consists of 56 mergers, 41 (friendly) acquisitions, 40 hostile acquisitions, 21 hostile acquisitions with multiple bidders and 29 divestitures. Twenty-four percent of all the bids were ultimately unsuccessful. The total number of bids can be subdivided into 118 domestic and 69 cross-border bids. Almost all the divestitures and 59% of the bids for entire companies were in cash only. Twenty-three percent of mergers and acquisitions bids were entirely equity-financed whereas the remainder was financed by a combination of cash, equity and loan notes. Table A.1 in Annex A summarises the bid characteristics of our sample.

Table A.2 of Annex A shows that 63% of the large European mergers and acquisitions bids launched over the period 1993-2000 targeted a firm in the same country as the one of the bidder. Although 63% of all domestic bids happened in the UK, UK targets and bidders were relatively less involved in cross-border acquisitions (with 27.5% of the total bids). German, Austrian and Swiss firms were almost as frequently involved in cross-border acquisitions as UK firms, both as bidders and targets. As expected, hostile bids are concentrated in the UK and Ireland: in these countries 77% of all domestic hostile bids and about half of all hostile cross-border bids were made. Additional data sources, the methodology to measure abnormal returns corrected for non-synchronous trading and the test-statistics used are presented in Annex B.

7.3 Target vs bidding firms

Panel A of Table 15 shows that the announcement of a takeover bid causes substantial positive abnormal returns for the shareholders of the target. On the event day, an

abnormal return of 9% is realised. Strikingly, as the cumulative abnormal returns over the event window starting two months (40 trading days) prior to and including the event date amount to about 23%, it seems that the bid was anticipated, probably as a result of rumours or of insider-trading. On average, investors owning a target company for a period starting three months prior to the event date (60 trading days) and selling at the end of the event day would earn a return of 24%. After about 30 trading days, the average cumulative abnormal return decreases by about 3% as a result of the fact that some bids are unsuccessful or the fact that a long period to finalise the offer raises doubt about the ultimate success of the negotiations.[10]

Panel B of Table 16 shows that the effect of the M&A announcement on the wealth of the bidding shareholders is small: at the announcement, there is an abnormal return of 0.7% (significant at the 1% level). For the five-day window centred on the event day, there is a statistically significant cumulative abnormal return of 1.2%. However, the CAARs for the longer event windows are not statistically significant. In the next subsection, we will show that the wealth effects for bidders are larger and depend upon the status of the bid (hostile vs friendly offer).

The CAARs obtained by this study are close to the ones reported by Franks and Harris (1989) and Higson and Elliott (1998). Franks and Harris report CAARs of 21% for large UK targets and of 0% for UK bidders over the period 1955-85 in the event month. Higson and Elliott find CAARs of 30% for the target shareholders in the largest bids and of 0% for the bidding shareholders over the period 1975-90. Recent research on the wealth effects for cross-border acquisitions by UK firms corroborates the results from earlier research that such operations do not generate any gain (or loss) for the bidding shareholders (Gregory and McCorriston, 2002; and Conn et al., 2001).

Table 15. Cumulative abnormal returns of target and bidding firms

Panel A. Target firms		
Time interval	CAAR (%)	t-value
[-1, 0]	9.01	29.53***
[-2, +2]	12.96	26.88***
[-40, 0]	23.10	17.62***
[-60, +60]	21.66	14.39***
Observations	136	
Panel B. Bidding firms		
Time interval	CAAR (%)	t-value
[-1, 0]	0.70	2.98***
[-2, +2]	1.18	3.18***
[-40, 0]	0.40	0.64
[-60,+60]	-0.48	-0.26
Observations	142	

Note: This table shows cumulative abnormal returns measured over several event windows for target and bidder firms. ***, ** and * stand for statistical significance at the 1%, 5% and 10% level, respectively.

Source: Own calculations.

[10] After the first announcement of a bid, it still takes several months before the merger or acquisition is accepted and the target firm stops trading. In only 11 out of 129 cases, the target firm is no longer traded within 40 trading days subsequent to the announcement. Respectively, 24 and 36 target firms are delisted 60 and 100 trading days subsequent to the announcement. We reduce the event window of target firms to 80 days after the event day.

7.4 Hostile vs friendly bids

We also analyse the market reactions to the different types of takeovers. For the target firms, we distinguish between mergers (40 cases), friendly acquisitions (53 cases), hostile acquisitions (28 cases) and bids with multiple bidders (14 cases). For all of these types of bids, there is a strong positive announcement effect (significant at the 1% level), as shown in Panel A of Table 16. As expected, hostile bids generate the largest abnormal returns for the target (13%) on the announcement day. These returns are significantly higher than the ones for the other types, i.e. only 9% for mergers and 6% for acquisitions. When a hostile bid is made, the share price of the target immediately reflects the expectation that opposition to the bid will lead to upward revisions of the offer price. Surprisingly, the announcement reaction to a situation with multiple bidders is low at 7%, but there is a large upward price movement starting already 1.5 months prior to the announcement. Panel A also reports that there are large differences in the price run-ups for the different types of bids. Whereas the upward price reactions prior to the bid announcement are limited to two weeks for hostile acquisitions and for friendly acquisitions, it seems that in the case of mergers, rumours or insider-trading occur already 1.5 to 2 months prior to the announcement (not shown). A hostile acquisition announcement generates a CAAR of more than 29% over the 2 month-period preceding and including the announcement day. At the event date and over the two months prior to the first announcement of the bid, the returns to the target shareholders for hostile acquisitions vastly outperform those of friendly mergers and acquisitions (Panel B of Table 16). The difference in returns between merger and friendly acquisition announcements is limited to the event date and to the 2-week period prior to the announcement. For the longer symmetric-event windows (six months and longer), differences between the types of bids are no longer statistically significant.

Panel C of Table 16 breaks down the CAAR for the bidder by type of bidding firm. The shareholders of bidding firms clearly react differently to announcements of mergers, acquisitions and hostile acquisitions. The abnormal return on the event day is 2.2% and 2.43% for mergers and unopposed acquisitions, respectively. On average, however, the bidder's shareholders seem to disapprove of hostile acquisitions. When the bid is contested, the announcement abnormal return is -2.5%. Panel D of Table 16 shows that the differences in abnormal returns are statistically significant at the 1% level.

Table 16. Cumulative abnormal returns of target and bidding firms by status of bid

Panel A. CAARs of target firms by status of bid

Time interval	Merger	t-value	Friendly acquisition	t-value	Hostile acquisition	t-value	Multiple bidders	t-value
Event window	%		%		%		%	
[-1, 0]	8.80	19.00***	5.96	6.34***	12.60	22.81***	6.98	8.62***
[-2, +2]	12.62	17.24***	11.33	7.62***	17.95	20.54***	11.28	8.82***
[-40, 0]	23.41	6.04***	20.34	5.41***	29.23	6.79***	23.68	2.87***
[-60, +60]	23.59	6.55***	26.52	3.62**	28.36	6.60***	20.53	3.26***
Observations	40		53		28		14	

Panel B. Significance of differences in target CAARs among status of bids

Event window	Hostile acquisition – Mergers	t-value difference	Hostile – Friendly Acquisition	t-value difference	Hostile acquisition – Multiple bidders	t-value difference	Mergers – Friendly acquisition	t-value difference
	%		%		%		%	
[-1, 0]	3.81	7.59***	6.64	10.40***	5.63	8.67***	2.83	
[-2, +2]	5.33	6.72***	6.62	6.56***	6.67	6.49***	1.29	1.48
[-40, 0]	5.82	3.59***	8.89	3.78***	5.55	3.51***	3.07	1.68
[-60, +60]	4.77	1.22	1.85	0.37	7.84	1.55	-2.92	0.68

Panel C. CAARs of bidding firms by status of bid

Time interval	Merger	t-value	Friendly acquisition	t-value	Hostile acquisition	t-value	Multiple bidders	t-value
Event day	%		%		%		%	
[-1, 0]	2.20	5.22***	2.43	5.06***	-2.51	-5.61***	-0.08	-0.13
[-2, +2]	4.35	6.55***	1.94	2.56***	-3.43	-4.85***	0.85	0.81
[-40, 0]	4.63	2.95***	4.86	2.45***	-2.51	-1.56	-1.04	-0.59
[-60, +60]	3.03	0.93	-1.67	-0.45	-0.69	-0.20	-2.96	-0.58
Observations	41		55		32		17	

Panel D. Significance of differences in bidder CAAR across status of bids

Event window	Hostile acquisition – Mergers	t-value difference	Hostile – Friendly acquisition	t-value difference	Hostile acquisition – Multiple bidders	t-value difference	Mergers – Friendly acquisition	t-value difference
	%		%		%		%	
[-1, 0]	-4.71	-10.89***	-4.94	-10.62***	-2.43	-4.59***	-0.23	0.51
[-2, +2]	-7.78	-11.38***	-5.37	-7.31***	-4.28	-5.11***	2.41	3.39***
[-40, 0]	-7.14	-5.66***	-7.37	-3.14***	-1.47	-1.28	-0.23	-0.31
[-60, +60]	-3.72	-1.10	-0.99	-0.27	2.28	0.55	4.70	1.35

Note: This table shows cumulative abnormal returns over several event windows for target firms and bidder firms by status of bid (merger, friendly acquisition, hostile acquisition, acquisition with multiple bidders). ***, ** and * stand for statistical significance at the 1%, 5% and 10% level, respectively.

Source: Own calculations.

7.5 The UK vs continental Europe

As 85% of the companies listed on the London Stock Exchange are widely held, there is an active market for corporate control and UK firms are continually up for auction. In contrast, in continental Europe the number of listed firms is much lower and most listed firms (around 85%-90% for Germany and France) have concentrated ownership or control (for a detailed overview of ownership and control in Europe, see Barca and Becht, 2001). Consequently, hostile acquisitions are rare in continental Europe. Not surprisingly, about half of the sample of target and bidding firms that are listed on a stock market are from the UK and Ireland (70 out of 136 targets and 66 out of 142 bidders). As there is a high degree of disclosure in the UK, a liquid and well developed equity market (McCahery and Renneboog, 2002) and a higher degree of shareholder protection (La Porta et al., 1997), we expect higher premiums in bids for UK firms.

Panel A of Table 16 confirms this conjecture: the announcement effect is substantially larger for the UK target firms (12.3%) than for continental European ones (6%). There is not much difference in terms of the price run-up in the targets prior to the announcement: in both continental Europe and in the UK, significant positive abnormal returns are generated two to three months prior to the announcement. UK target shareholders who own equity as of two months prior to the announcement and sell on the day of the announcement can earn (on average) a premium of more than 38%, more than double the return earned by the continental European target shareholders (15%) over the same period (Panel A of Table B.1 in Annex B). Whereas the post-announcement CAARs are not statistically different from zero, they are substantially negative for continental European targets for the 1.5 to three months after the announcement day. Hence, in spite of the lower bid premiums in continental Europe, it seems that the market price reactions to the announcements are over-optimistic and that returns are subsequently corrected.[11]

Panel B of Table 17 reports the returns for the shareholders of the bidding firms. Bidding shareholders in UK firms earn more than those in continental European firms. Over a five-day window centred on the announcement date, UK bidders obtain a cumulative abnormal return of 1.5% versus only 0.9% for continental European bidders. Whereas there is evidence of trading on rumours in the target shares or of insider-trading, this is not the case for the bidding firms.

Table 17. Cumulative abnormal returns of target and bidding firms: The UK vs continental Europe

Panel A. CAARs of target firms: UK vs continental Europe						
Time interval	UK	t-value	Continental Europe	t-value	UK – Continental	t-value differences
Event window	%		%		%	
[-1, 0]	12.31	29.09***	5.95	13.99***	6.35	14.96***
[-2, +2]	17.42	26.03***	8.85	13.15***	8.56	12.75***
[-40, 0]	38.30	14.66***	14.95	7.56***	23.35	5.64***
[-60, +60]	29.32	8.91***	14.82	4.48***	14.49	4.39***
Observations	70		66			

Panel B. CAARs of bidding firms: UK vs continental Europe						
Time interval	UK	t-value	Continental Europe	t-value	UK – Continental	t-value on differences
Event window	%		%		%	
[-1, 0]	1.04	3.41***	0.40	1.19	0.64	1.98*
[-2, +2]	1.51	3.11***	0.90	1.69*	0.60	1.17
[-40, 0]	1.19	0.92	0.35	0.22	0.84	0.68
[-60, +60]	-1.65	-0.69	0.54	0.21	-2.193	-0.87
Observations	66		76			

Note: This table shows cumulative abnormal returns over several event windows for target firms and bidder firms by location (UK vs continental Europe). ***, ** and * stand for statistical significance at the 1%, 5% and 10% level, respectively.

Source: Own calculations.

[11] The post-announcement correction in abnormal returns is not due to a higher rate of failed bids, as there are more failed bids (related to hostile takeover attempts) in the UK than in continental Europe.

7.6 Domestic vs cross-border acquisitions

In this section, we distinguish between domestic and cross-border bids. As pointed out before, 63% of large European mergers and acquisitions are domestic. Table 18 shows that the announcement effect for domestic and cross-border targets amounts to 10.2% and 11.3%, respectively; the difference is not statistically significant. However, when we include the price run-up period (40 trading days prior to the event), we find a statistically significant difference (within the 5% level) of 2.9% (22.7% minus 18.8%). The main reason why on average higher premiums are paid for domestic targets than for cross-border targets is that the sample of domestic M&As includes a higher proportion of UK targets (46% vs 28% in the cross-border takeover sample; see Table A.2 of Annex A).

In all countries (apart from the Benelux countries), higher premiums are paid for targets in cross-border bids than for those in domestic M&As. This is surprising as UK firms are more frequently the target of hostile domestic acquisitions than of hostile cross-border bids. In the following sections, we further investigate whether other bid characteristics (such as the means of payment) can explain the higher CAARs in cross-border acquisitions.

Table 18. Cumulative abnormal returns of domestic and cross-border bids

	Domestic M&A					Cross-border M&A				
	Number	Listed target		Listed bidder		Number	Listed target		Listed bidder	
	of deals	%	t-stat	%	t-stat	of deals	%	t-stat	%	t-stat
All countries	Obs: 118	Obs: 85		Obs: 86		Obs:69	Obs:49		Obs: 56	
[-1,0]		10.22	28.776***	-0.45	-1.604		11.25	23.247***	2.38	6.389***
[-2,+2]		12.72	22.645***	-0.10	-0.222		13.51	17.656***	3.09	5.247***
[-40, 0]		22.74	14.139***	-0.57	-0.446		19.81	9.044***	1.48	0.880
[-60, +60]		22.87	8.277***	-0.53	-0.242		19.49	5.178***	-0.41	-0.142
UK+Ireland	Obs:74	Obs: 56		Obs: 52		Obs: 19	Obs: 14		Obs: 14	
[-1,0]		12.89	30.559***	-1.27	-3.979***		15.27	16.196***	6.29	7.793***
[-2,+2]		15.68	23.508***	-0.60	-1.190		17.61	11.811***	9.17	7.185***
[-40, 0]		26.99	14.135***	-1.28	-0.884		31.24	7.317***	4.91	1.344
[-60, +60]		27.78	8.468***	-2.20	-0.885		33.28	4.537***	0.34	0.054
Germany/Aust/ Switz	Obs: 7	Obs: 6		Obs: 4		Obs: 18	Obs: 12		Obs: 12	
[-1,0]		6.77	5.092***	3.76	3.114***		10.72	9.110***	0.31	0.515
[-2,+2]		7.21	3.430***	1.98	1.038		13.39	7.199***	-1.93	-1.580
[-40, 0]		14.53	2.412***	-2.00	-0.365		13.70	2.573***	-1.85	-0.479
[-60, +60]		-0.59	-0.057	-8.95	-0.952		8.11	0.887	-5.99	-0.893
France	Obs: 16	Obs: 11		Obs: 13		Obs: 7	Obs: 3		Obs: 13	
[-1,0]		3.58	3.976***	-1.72	-2.105**		5.90	4.498***	0.98	1.623
[-2,+2]		4.29	3.013***	-1.91	-1.478		9.60	4.628***	2.83	2.093**
[-40, 0]		11.81	2.895***	-1.39	-0.375		8.35	1.406	-0.85	-0.220
[-60, +60]		17.15	2.446***	3.23	0.508		8.34	0.817	12.68	1.904*

Scandinavia	Obs: 3	Obs: 1		Obs: 3		Obs: 13	Obs: 11		Obs: 5	
[-1,0]		1.23	0.354	0.53	0.265		11.33	8.881^{***}	1.47	1.303
[-2,+2]		-0.36	-0.066	2.02	0.637		11.10	5.505^{***}	-1.33	-0.527
[-40, 0]		38.84	2.466^{***}	5.83	0.644		19.30	3.340^{***}	0.76	0.105
[-60, +60]		27.78	1.027	11.87	0.763		16.96	1.708^{*}	-11.31	-0.909
Benelux	Obs: 6	Obs: 4		Obs: 4		Obs: 8	Obs: 7		Obs: 8	
[-1,0]		13.79	6.158^{***}	6.45	5.523^{***}		10.98	8.519^{***}	2.40	2.429^{***}
[-2,+2]		13.96	3.943^{***}	9.59	5.197^{***}		17.73	8.700^{***}	2.19	1.569
[-40, 0]		22.42	2.211^{**}	4.64	0.878		16.98	2.910^{***}	0.80	0.178
[-60, +60]		20.81	1.195	4.88	0.537		10.98	1.095	-7.20	-0.938
Southern Europe	Obs: 10	Obs: 7		Obs: 8		Obs: 4	Obs: 2		Obs: 4	
[-1,0]		2.31	2.011^{**}	-0.09	-0.067		8.07	3.257^{***}	1.29	1.559
[-2,+2]		7.78	4.281^{***}	-0.85	-0.404		8.17	2.085^{**}	5.52	2.978^{***}
[-40, 0]		6.20	1.192	-0.61	-0.101		20.01	1.784^{*}	13.23	2.493^{***}
[-60, +60]		1.85	0.207	-3.84	-0.371		10.50	0.545	5.22	0.573

Note: This table shows the percentage abnormal returns for different event windows for listed target and bidder firms of domestic and cross-border acquisitions. The number of deals refers to the number of takeover announcements. ***, ** and * stand for statistical significance at the 1%, 5% and 10% level, respectively.

Source: Own calculations.

7.7 Means of payment in takeover bids

The average bid value of our sample is $547 billion. The distribution of the bid value is highly skewed, as the median value is only $575 million. The majority of bids (excluding the bids on divestitures) are cash offers (93 out of 156 cases or 60%). Twenty-four per cent of the offers are all-equity offers and the remainder consists of combinations of cash and equity (11%), of cash and loan notes (2%) of equity and loan notes (2%), and of cash, equity and loan notes (1%). Payment for smaller targets is usually done in cash: the average value of all-cash offers amounts to $149 billion while that of all-equity offers is $1,426 billion (with medians of $443 million and $258 billion, respectively). In 12 cases out of the 93 all-cash offers, the bidder also gave the target the opportunity to accept an all-equity offer or a combined offer (with a higher value than the cash offer).[12]

If the managers of an acquiring firm know that their shares are worth more than their current market price, they should prefer to finance the acquisition with cash. Hence, future changes in the stock price will only benefit the shareholders of the bidding firm. Conversely, if the bidding management believes that its stock is overvalued, they should prefer to pay for the acquisition with equity. Hence, asymmetric information between the bidder's management and outside investors on the bidder's market value may have some bearing on the choice between cash or equity payments in an offer.

[12] This choice between an all-cash offer and a combined cash-and-equity offer is given in all 12 cases at the first announcement of the bid. In contrast, in four cases, a cash offer was added to an initial all-equity or combined offer as a sweetener some time after the first announcement.

We find strong evidence that the share price reaction for the target is sensitive to the means of payment for its shares. Cash offers trigger substantially higher abnormal returns (10% at the announcement) than offers including the bidders' equity (6.7%) and combined offers of cash and equity (5.6%). Panel A of Table 19 also shows that when the price run-up starting two weeks prior to the event day is included, cash offers trigger CAARs of almost 20% vs 14% and 12.5% for all-equity bids and combined bids, respectively. Panel B shows that whatever the event window, the CAARs of cash-financed bids are significantly higher than those of other bids at the 1% significance level. Panel B of Table 19 shows an entirely different picture for bidding firms. Over both short- and longer-term windows, the shareholders of the acquiring firms greet equity offers more favourably (1%) than cash offers (0.4%). This implies that the choice to make an all-equity offer does not suggest to the market that the bidder's equity is overvalued. Within the sample of large take-over bids, the relatively smaller ones are all-cash bids, whereas the relatively larger ones involve equity. Consequently, it may be that the market realises that for large deals the choice of means of payment is restricted.

Table 19. Cumulative abnormal returns of target and bidding firms by means of payment

Panel A. CAARs of target firms by means of payment						
Time interval	Cash bid	t-value	Equity bid	t-value	Combined bid	t-value
[-1, 0]	9.89	35.81***	6.65	16.07***	5.63	11.68***
[-2, +2]	13.56	21.95***	11.38	12.30***	13.24	12.28***
[-40, 0]	27.49	15.54***	12.23	4.62***	16.81	5.44***
[-60, +60]	28.75	9.46***	12.89	2.83***	5.66	1.07
Observations	88		30		18	

Panel B. Significance of differences in target CAARs among types of payment						
	Cash offers – Equity offers	t-value difference	Cash offers – Combined offers	t-value difference	Equity offers – Combined offers	t-value difference
Event window	%		%		%	
[-1, 0]	3.24	36.10***	4.26	30.81***	1.01	0.20
[-2, +2]	2.18	10.84***	0.32	1.02	-1.86	-0.24
[-40, 0]	15.26	26.52***	10.68	12.07***	-4.58	-0.35
[-60, +60]	15.86	16.04***	23.09	15.19***	7.23	0.43

Panel C. CAARs of bidding firms by means of payment						
Time interval	Cash bid	t-value	Equity bid	t-value	Cash/equity/ loan notes bid	t-value
Event day	%		%		%	
[-1, 0]	0.37	1.68*	0.98	3.01***	0.13	0.35
[-2, +2]	0.90	1.83*	2.57	3.52***	0.22	0.27
[-40, 0]	-1.18	-0.84	5.15	2.46**	-0.20	-0.09
[-60, +60]	-1.44	-0.59	2.72	0.76	-1.39	-0.34
Observations	86		33		23	

Panel D. Significance of differences in bidder CAAR across types of payment						
	Cash offers – Equity offers	t-value difference	Cash offers – Combined offers	t-value difference	Equity offers – Combined offers	t-value difference
Event window	%		%		%	
[-1, 0]	-0.61	-9.95***	0.24	2.97***	0.85	8.93***
[-2, +2]	-1.67	-12.08***	0.68	3.79***	2.35	11.00***
[-40, 0]	-6.33	-16.01***	-0.98	-1.89*	5.36	8.75***
[-60, +60]	-4.16	-6.11***	-0.05	-0.05	4.11	3.91***

Note: This table shows cumulative abnormal returns over several event windows for target firms and bidder firms by means of payment (all-cash, all-equity or a combination of cash, equity and/or loan notes). ***, ** and * stand for statistical significance at the 1%, 5% and 10% level, respectively.

Source: Own calculations.

7.8 Takeover bids by industry

In this sub-section, we check whether our results are driven by particular industries. We created the following five industry groups based on the SIC classification: i) energy, natural resources, waste development and utilities (9 firms), ii) production and manufacturing (49 firms), iii) services (36 firms), iv) retailers, stores, pubs, hotels (23 firms) and v) banking and insurance (19 firms). On the announcement day, bids for retail and manufacturing firms trigger the strongest positive abnormal returns, 14.4% and 10.9%, respectively (Panel A of Table 20). For longer time intervals of e.g. two months, there are no substantial differences between the different industries. Our results for banks are consistent with the findings of Cybo-Ottone and Murgia (2000), who found a significant and positive 15.3% announcement effect for European target banks. The strong decline in abnormal returns of financial and energy target firms reflects the fact that a few of the bids were ultimately unsuccessful.

Table 20. Cumulative abnormal returns of target and bidding firms by industry

Panel A. Cumulative abnormal returns of target firms by industry										
Time interval	Energy	t-value	Manufac.	t-value	Services	t-value	Retailer	t-value	Bank	t-value
Event day	%		%		%		%		%	
.[-1, 0]	5.06	4.57***	10.87	25.77***	7.34	10.48***	14.35	17.99***	4.03	5.48***
[-2, +2]	6.83	3.90***	15.16	22.73***	10.50	9.48***	16.87	13.38***	10.06	8.63***
[-40, 0]	17.28	3.99***	26.53	15.34***	25.22	6.04***	17.31	10.04***	18.31	7.39***
[-60, +60]	21.30	2.78**	24.86	7.58***	27.10	4.98***	18.22	2.94**	8.83	1.54
Observations	9		49		36		23		19	
Panel B. Cumulative abnormal returns of bidding firms by industry										
Time interval	Energy	t-value	Manufac.	t-value	Services	t-value	Retailers	t-value	Bank	t-value
Event day	%		%		%		%		%	
.[-1, 0]	-1.91	-1.98*	1.89	5.00***	-2.35	-4.43***	2.07	3.94***	0.44	0.75
[-2, +2]	-0.83	-0.54	2.92	4.88***	-2.19	-2.61**	2.19	2.64**	-0.15	-0.16
[-40, 0]	-4.83	-1.46	0.12	0.11	-1.56	-1.73*	5.13	1.78*	-1.85	-0.99
[-60, +60]	7.64	1.02	-1.66	-0.56	2.90	0.70	5.37	1.32	-8.95	-1.96*
Observations	9		63		28		20		22	

Note: This table shows cumulative abnormal returns over several event windows for target firms and bidder firms by industry. ***, ** and * stand for statistical significance at the 1%, 5% and 10% level, respectively.

Source: Own calculations.

However, the picture for bidding firms by industry looks different. Some industries show positive CAARs (manufacturing, retailing) whereas other industries have negative announcement effects (energy, services). The latter difference is largely due to the fact that the energy and services industries count more hostile acquisitions. Financial bidders (banks and insurance companies) realise insignificant positive returns, but significantly negative CAARs over longer time periods (Panel B of Table 20). These findings are consistent with those from Cybo-Ottone and Murgia (2000) for Europe and Frame and Lastrapes (1998) for the US.

7.9 Timing of bids made at different periods in the M&A wave

M&A activity during the 1990s is characterised by continuous increases in volume, in average bid value and hence in total bid value. European M&A activity grew in value by more than 280% over the period of 1996-99. The year 1999 was not only remarkable in terms of the total bid value ($156 billion), but also in terms of the number of hostile acquisitions: there was a staggering number of 369 hostile offers. Shelton (2000) reports evidence that bidder gains fall during merger peaks, suggesting that bidders are more aggressive, display greater tendencies to over-pay for target firms or assume more risk in pursuing M&A projects. Hence, we split the bids into two categories based on the year/period in which they were made. We do not find that the takeover bids trigger larger cumulative abnormal returns at the height of the takeover wave.

7.10 Aggregate analysis

The analysis in previous sub-sections focused on the univariate relations between M&A premiums, the composition of the takeover and the bidder and target firm. In this section, we analyse which of these effects dominates. We regress the cumulative abnormal returns of target and bidding firms (in separate regressions) over two different windows ([-1, 0] and [-10,0]) on variables capturing:

i) the status of the bid (merger, friendly acquisition, hostile acquisition);

ii) the means of payment (all-cash offer, all-equity offer or a combination of cash, equity or loan notes);

iii) the takeover characteristics (relative size: target/bidder);

iv) the target and bidder characteristics (net cash held by target over market value of equity, performance of target, interest coverage of target, growth potential of target (MV/BV), degree of diversification of bidder, industry of target and bidder); and

v) the location of the target and bidder firm (domestic vs cross-border; and country of the target).

We correct both target and bidder regressions for industry effects. The sample size is 136 for the target firms and 142 for the bidder firms.

Table 21 shows that the status of the bid is an important determinant of the short-term wealth effects (on the event day and for the ten-day period including the price run-up) for both target and bidder firms. In comparison to merger offers, hostile bids trigger large positive abnormal returns for the target shareholders but significantly negative abnormal returns for the bidder. This follows from the fact that bidder shareholders are fearful that the management's motives for the bid are hubris or agency-related. In

contrast, target shareholders expect that opposition against the offer will lead to upwardly revised bid prices. Friendly acquisitions are slightly underperforming – from the perspective of the target shareholders – other types of bids. When the offer is entirely cash-financed, the target's share price will increase more than when the bid consists of an all-equity offer or a combination of equity, cash and loan notes. An all-cash offer may signal that the bidder's equity is undervalued. It may also signal the bidder's confidence in successfully exploiting the potential synergies as the bidder does not want to share future value creation with the target shareholders. However, for the very large targets, it may be difficult to raise large amounts of cash such that the bidder has to resort to an all-equity offer or at least a combined offer. The share price reaction for bidding firms to a cash offer is (weakly) negative. This may result from the market's concern that management may bid too high a premium whereas when the target shareholders accept an equity offer, they share some of the risk from the acquisition.

The impact of the following target and bidder characteristics is also investigated: the relative size of the target's market capitalisation compared to that of the bidder, the cash reserves held by the target firm, the target's market-to-book ratio, the target's return on equity and interest coverage, the degree of the bidder's diversification, the fact whether or not bidder and target are operating in the same industry and the country in which the target is located. Table 21 shows that relative size is not significant, which may be explained by the fact that this study only concentrates on large European deals (of over $100 million). The amount of cash reserves held by the target company may have an impact on the size of the bid premium and hence on the announcement effect, because a target firm with substantial cash reserves may in fact provide the bidder with part of the necessary finance to fund the merger or acquisition. However, Table 21 shows that this is not the case for the firms in our sample. For a target firm with strong growth opportunities (as reflected in a high market-to-book ratio), the market expects a premium, whereas Table 21 suggests that the market is anxious that the bidder will overpay for growth options.[13]

Whereas the financial distress measure (interest coverage) does not have any bearing on the abnormal returns of the targets and bidders, there is some (weak) evidence that the target's performance (measured by the return on equity) is positively related to the merger or acquisition premium. The fact that a bidder implements a focused merger or acquisition strategy (i.e. taking over a firm in the same industry) does not have any short-term wealth effects on the bidder or target. In contrast, we find some evidence of significantly negative abnormal returns (at the 10% level) for bidders that are already diversified. The regressions also analyse whether the premiums are influenced by domestic or cross-border mergers and acquisitions. We find evidence (at the 10% level) that domestic M&As are triggering a higher premium of around 1% for the target even after correcting for the status of the takeover. However, bidders in domestic mergers and acquisitions bids earn marginally negative abnormal returns of 0.7%.

[13] Substituting price/cash flow for market-to-book did not yield significant results.

Table 21. Determinants of short-term wealth effects for target and bidding firms

	Target firms				Bidder firms			
Dep variable	CAAR [-1, 0]		CAAR [-10, 0]		CAAR [-1, 0]		CAAR [-1, 0]	
	Coeff.	t-value	Coeff.	t-value	Coeff.	t-value	Coeff.	t-value
Intercept	0.0510	2.311**	0.0715	2.877***	0.0588	2.371***	0.0687	2.466***
Bid characteristics								
Hostile acquisition	0.0235	2.006**	0.0731	2.239**	-0.0573	-2.737***	-0.0663	-2.637***
Friendly acquisition	-0.0177	-1.787*	-0.0141	1.777*	0.0266	0.456	0.0101	0.460
Cash payment	0.0748	2.152**	0.0699	2.515***	-0.0332	-1.858*	-0.018	-1.572
Bidder and target characteristics								
Relative size (target/bidder)	0.0014	0.220	0.0018	0.469	0.0054	0.673	0.0015	0.563
Target cash reserves/market cap.	-0.0534	-1.005	0.0290	0.284	0.0011	0.738	0.0008	0.351
Target market-to-book ratio	0.0016	1.789*	0.0020	1.911*	-0.0021	-2.595***	-0.0029	1.728*
Target ROE	0.0333	1.687*	0.0518	1.566	-0.0156	-1.004	0.0064	0.452
Interest coverage	-0.0091	-1.214	-0.0061	-0.673	0.0014	0.490	0.0015	0.631
Bidder diversification	0.0694	0.583	0.0135	0.241	-0.0096	-1.721*	-0.0088	-1.689*
Bidder and target: same industry	-0.0572	-1.444	-0.1005	-1.351	0.252	1.461	0.374	0.637
M&A location								
Domestic M&A	0.0251	1.602	0.0114	1.742*	-0.0074	-1.688*	-0.0014	-0.863
UK target	0.0712	2.355***	0.0961	2.532***	0.0327	1.956*	0.0332	1.819*
German/Central European target	0.0199	2.005**	0.0138	1.798*	0.0210	2.636***	0.0056	1.647
Southern European target	0.0089	1.864*	0.0067	1.372	0.0069	1.254	0.0007	1.035
Industries								
Energy	-0.0370	-0.229	-0.1051	-0.674	-0.0324	-0.684	-0.0943	-0.634
Services	-0.8529	-0.738	-0.0467	-0.663	-0.2511	-1.221	-0.6866	-0.013
Retail	-0.5628	-0.330	0.0998	0.421	0.0999	0.997	0.0142	0.852
Financial	0.1411	0.454	0.3145	1.271	-0.4126	-0.637	-0.0853	-0.462
Observations	136		136		142		142	
R^2	0.304		.350		0.331		0.379	
Adjusted R^2	0.152		0.215		0.223		0.246	
Signif. of F-value	0.009		0.003		0.001		0.001	

Note: This table shows OLS regressions of cumulative abnormal returns over different event windows for target and bidder firms. Hostile acquisition is a dummy variable that equals 1 if the target's board opposes the acquisition or when there are multiple bidders. A friendly acquisition is accepted by the target's board and is not a merger (as indicated by the M&A Report). The variable cash payment is 1 when the bid is made in cash only. The relative size is total assets of target divided by total assets of the bidder. ROE stands for return on equity. Bidder diversification is a dummy variable capturing whether the bidder is diversified (dummy=1) or is a single-industry company. Bidder and target are in the same industry indicates whether the M&A is the result of a focus strategy (dummy equal to 1). Domestic M&A is a dummy variable indicating whether or not the target and the bidder are in the same country. UK target, German/Central European target, and Southern European target are dummy variables capture whether the target firm is located in, respectively, the UK, Germany/Austria/Switzerland/Poland, and Italy/Spain/Portugal/Greece. The benchmark is France/Benelux. ***, ** and * stand for statistical significance at the 1%, 5% and 10% level, respectively.

Source: Own calculations.

We also investigate whether the location of the target has an impact on abnormal returns. We distinguish between targets located in i) the UK, ii) Germany, Austria, Switzerland and Central Europe, iii) southern Europe and iv) France and the Benelux countries. We find strong evidence that bids involving UK targets generate significantly positive short-term wealth effects for both the bidder and target shareholders: the target's abnormal returns increase by 7 to 9.6% and the ones for bidder increase by around 3.3%. In bids involving German, Austrian and Swiss targets, wealth effects are also positive but lower (between 0.6-2.1%). As we already control for effects such as the status of the bid, industry, financial characteristics of the target and means of payment, the finding that the location is an important determinant may be due to institutional differences. The latter are an amalgam of ownership patterns (with the UK having a higher free float than continental Europe), protection of shareholder rights (with the UK having a higher degree of protection than continental Europe according to La Porta et al., 1997) and takeover regulation (with higher transparency in the UK).

7.11 Conclusions

We find large announcement effects of 9% for target firms, but the cumulative abnormal return that includes the price run-up over the two-month period prior to the announcement rises to 23%. Bidders react positively with a statistically significant announcement effect of only 0.7%. We also show that the status of the bid has a large impact on the short-term wealth effects for the target and bidder shareholders. For hostile acquisitions, the announcement effect for target firms is substantially higher (12.6% on day 0 and almost 30% including the price run-up) than the one for mergers and friendly acquisitions (8% on day 0 and 22% including the price run-up). Hence, the market seems to expect that opposition against a bid will lead to a revision of the offer and ultimately to a higher bid premium. This is confirmed by the share price reaction of bidding firms: a hostile acquisition triggers a negative abnormal return of 2.5% whereas the announcement of a merger or friendly acquisition generates a positive abnormal return of 2.5%. The location of bidder and target firms also seems to have an important impact on short-term wealth effects: both UK bidders and targets generate significantly higher returns than their continental European counterparts. This can partially be explained by the higher incidence of hostile acquisitions in the UK and the more developed UK market for corporate control.

We also find strong evidence that the means of payment has a large impact on the wealth effect. All-cash offers trigger an abnormal return of almost 10% upon announcement (27.5% including price run-up) whereas all-equity bids or offers combining cash, equity and loan notes only generate a return of 6% (14% including the price run-up). Cash bids are more frequent for smaller targets, though. The market reacts more positively (+1%) to bidding firms that use equity to pay for the merger or acquisition. This implies that the choice of the means of payment does not act as a signal to the market about the over- or undervaluation of the bidder's equity.

A high market-to-book ratio for the target leads to a higher bid premium combined with a negative abnormal return for the bidder. We also find that bidding firms should not further diversify by acquiring target firms that do not match their core business. An interesting result is that domestic mergers or acquisitions trigger higher wealth effects than cross-border ones. This is surprising as foreign direct investment theories predict

that foreign bidders may be able to take advantage of imperfections in factor and capital markets and thereby generate more gains. Consequently, bidders in cross-border transactions were expected to pay higher premiums, which according to our analysis they do not. We also find that the premiums paid depend on the location of the target.

8. What determines the premiums in European takeover bids? Empirical Evidence of the Impact of Corporate Governance Regulation

La Porta et al. (1997, 1998, 2000) demonstrate that there is a relation between legal origin (respectively, the English, French, German and Scandinavian legal system) and financial market development, as shown in Section 2 of this report. By country, they construct a shareholder protection index (from 0-6) which is based on whether proxy voting is allowed by mail, whether shares are blocked prior to the meeting, whether cumulative voting is allowed for director appointments, whether there is a shareholder minority protection mechanism in place, whether the shareholders receive pre-emptive rights to purchase shares in a seasoned equity offering and whether the one-share/one-vote mechanism is upheld (see Table 22). Similarly, they construct a creditor protection index (from 0 to 4) which is based on bankruptcy legislation and is higher when approval is needed to petition for reorganisation, there is no automatic stay on assets, when secured creditors are first in a liquidation and when management does not stay in a corporate restructuring. They also collect data to measure how the rule of law is upheld in courts and to measure the accounting standard in a country.

We expand the regressions in previous subsections by these corporate control factors and examine whether these regulatory corporate governance variables can explain some of the cross-sectional variance in the premiums paid in takeovers while controlling for the characteristics of the bid, the bidder and the target. Table 23 shows that a lower premium is offered when the shareholder rights index of the bidding shareholders is high. This suggests that when the shareholders of the bidder are powerful, they ensure that the bidding management does not make too high a bid on the target. We also find that when the accounting standards of the target firm are high, a higher bid for the target is made while controlling for the status of the bid, the means of payment, relative size of target and bidder, performance, the degree of bidder diversification, whether or not the bid is a cross-border bid. This result is important as it shows that bidding firms are willing to pay relatively higher premiums for companies with better transparency created by higher accounting standards. Finally, Table 23 also shows some weak evidence that when the shareholders of the target firm are powerful (as reflected in a high shareholder rights index), the premium offered by the bidder is higher.

Table 24 details the analysis of Table 23 by replacing the shareholder and creditor protection indices by the components of the indices. We find that the negative impact on the premium offered is related to strong shareholder protection on the side of the bidder and more specifically to the fact that bidding shareholders can use proxy votes by mail, to the fact that the shares are not blocked before the annual meeting and to the fact that an oppressed minority mechanism is in place. Table 24 confirms that the bidder is willing to pay a higher premium when the accounting standards are high. Furthermore, when the principle of one-share/one-vote is upheld by the target firm – this means that there are no pyramids or multiple voting shares – a higher premium is offered for the target shares.

Table 22. Corporate governance regulation

	Austria	Belgium	Denmark	Finland	France	Germany	Greece	Ireland	Italy	Netherl.	Norway	Portugal	Spain	Sweden	Switzerland	UK
Ln (GBP/capita)	10.07	9.98	10.19	9.87	10.02	10.07	8.91	9.47	9.90	9.95	10.16	9.12	9.52	10.12	10.48	9.80
Panel A: Legal origin																
Civil law = 1 (common law =0)	1	1	1	1	1	1	1	0	1	1	1	1	1	1	1	0
Legal origin = UK	0	0	0	0	0	0	0	1	0	0	0	0	0	0	0	1
Legal origin = France	0	1	0	0	1	0	1	0	1	1	0	1	1	0	0	0
Legal origin = Scandinavia	0	0	1	1	0	0	0	0	0	0	1	0	0	1	0	0
Legal origin = Germany	1	0	0	0	0	1	0	0	0	0	0	0	0	0	1	0
Panel B: Shareholder rights																
Shareholder protection index (0-6)	2	0	2	3	3	1	2	4	1	2	4	3	4	3	2	5
Proxy voting by mail allowed (yes=1)	0	0	0	0	1	0	0	0	0	0	1	0	0	0	0	1
Shares are not blocked before annual meeting (=1)	0	0	1	1	0	0	0	1	0	0	1	1	0	1	0	1
Cumulative voting for director (yes=1)	0	0	0	0	0	0	0	0	0	0	0	0	1	0	0	0
Oppressed minorities mechanism in place (=1)	0	0	0	0	0	0	0	1	0	0	0	0	1	0	0	1
% votes to call extraord. shareholders meeting	0.05	0.2	0.1	0.1	0.1	0.05	0.05	0.1	0.2	0.1	0.1	0.05	0.05	0.1	0.1	0.1
Pre-emptive rights for new issues (yes=1)	1	0	0	1	1	0	1	1	1	1	1	1	1	1	1	1
One-share/one-vote in corporate law (yes=1)	0	0	0	0	0	0	1	0	0	0	0	0	0	0	0	0
Panel C: Creditor rights																
Creditors rights(0-4)(L&F)	3	2	3	1	0	3	1	1	2	2	2	1	2	2	1	4
Approval needed to petition for reorganisation=1	1	0	1	0	0	1	0	0	1	1	1	0	0	1	0	1
No automatic stay on assets (=1)	1	1	1	0	0	1	0	0	0	0	0	0	1	0	0	1
Secured creditors 1st in liquidation (yes=1)	1	1	1	1	0	1	0	1	1	1	1	1	1	1	1	1
Management does NOT stay in restructuring=1	0	0	0	0	0	0	1	0	0	0	0	0	0	0	0	1
% of secured creditors to approve restructuring	100	100	100	51	0	100	80	51	100	100	100	100	100	100	100	100
Panel D: Measures of enforcement																
Efficiency of judicial system	9.5	9.5	10	10	8	9	7	8.75	6.75	10	10	5.5	6.25	10	10	10
Rule of law (0 to 10)	10.00	10.00	10.00	10.00	8.98	9.23	6.18	7.80	8.33	10.00	10.00	8.68	7.80	10.00	10.00	8.57
Risk of contract repudiation (0-10)	9.6	9.48	9.31	9.15	9.19	9.77	6.62	8.96	9.17	9.35	9.71	8.57	8.4	9.58	9.98	9.63
Risk of expropriation (0-10)	9.69	9.63	9.67	9.67	9.65	9.9	7.12	9.67	9.35	9.98	9.88	8.9	9.52	9.4	9.98	9.71
Accounting standards (0-100)	54	61	62	77	69	62	55	NA	62	64	74	36	64	83	68	78
Panel E: Mandatory dividends and legal reserves																
Mandatory dividend in law	0	0	0	0	0	0	0.35	0	0	0	0	0	0	0	0	0
% of profits required for legal reserve	0.1	0.1	0.25	0	0.1	0.1	0.33	0	0.2	0	0.2	0.2	0.2	0.2	0.5	0

Sources: La Porta et al. (1998, 2000).

Table 23. Regulatory determinants of short-term wealth effects for bidding firms

	Bidder firms			
Dep. variable	CAAR [-1, 0]		CAAR [-10, 0]	
	Coeff.	t-value	Coeff.	t-value
Intercept	0.0328	2.490***	0.0598	2.622***
Corporate governance regime of bidder				
Shareholder rights index (0-6)	-0.0084	-2.002**	-0.0121	-1.983**
Creditor rights (0-4)	0.0005	0.619	0.0012	0.726
Rule of Law (0-10)	0.0007	0.281	-0.0071	-0.427
Corporate governance regime of target				
Shareholder rights index (0-6)	0.0071	1.562	0.0079	1.736*
Creditor rights (0-4)	-0.0344	-1.042	-0.0521	-1.211
Rule of law (0-10)	0.0015	0.141	0.0009	0.315
Accounting standards (0-100)	0.1055	2.059**	0.1311	2.261**
Bid characteristics				
Hostile acquisition (=1)	-0.0338	-2.747***	-0.0327	-2.353***
Friendly acquisition (=1)	0.0153	0.858	0.0311	1.661*
Cash payment (=1)	-0.0081	-1.725*	-0.0068	-1.473
Bidder and target characteristics				
Relative size (target/bidder)	0.0009	0.241	0.0013	0.432
Target cash reserves/Market cap.	0.3215	0.553	0.2188	0.621
Target market-to-book ratio	-0.0072	-2.411***	-0.0080	-1.928*
Target ROE	-0.0089	-0.968	0.0034	0.239
Interest coverage	0.0164	0.732	0.0084	0.361
Bidder diversification	-0.0122	-1.818*	-0.0094	-1.669*
Bidder and target: same industry	0.0960	1.699*	0.1374	1.020
M&A location				
Cross-border M&A (=1)	0.00768	1.655*	-0.0044	-0.326
Industries	Yes		Yes	
Years	Yes		Yes	
Observations	142		142	
R^2	0.361		0.342	
Adjusted R^2	0.242		0.218	
Signif. of F-value	<0.001		<0.001	

Notes: This table shows OLS regressions of cumulative abnormal returns over different event windows for bidder firms. Hostile acquisition is a dummy variable that equals 1 if the target's board opposes the acquisition or when there are multiple bidders. A friendly acquisition is accepted by the target's board and is not a merger (as indicated by the M&A Report). The variable cash payment is 1 when the bid is made in cash only. The relative size is total assets of target divided by total assets of the bidder. ROE stands for return on equity. Bidder diversification is a dummy variable capturing whether the bidder is diversified (dummy=1) or is a single-industry company. Bidder and target are in the same industry indicates whether the M&A is the result of a focus strategy (dummy equal to 1). Cross-border M&A is a dummy variable indicating whether or not the target and the bidder are in the same country. The shareholder rights index, the creditor rights index, the rule of law and accounting standards are defined above. ***, ** and * stand for statistical significance at the 1%, 5% and 10% level, respectively.

Source: Own calculations.

Table 24. Regulatory determinants of short-term wealth effects for bidding firms: Details

Dep. Variable	Bidder firms			
	CAAR [-1, 0]		CAAR [-10, 0]	
	Coeff.	t-value	Coeff.	t-value
Intercept	0.0422	2.311***	0.0592	2.620***
Corporate governance regime of bidder				
Proxy voting by mail allowed (yes=1)	-0.0031	-1.703*	-0.0279	-1.603
Shares not blocked before annual meeting (=1)	-0.0025	-1.645*	-0.0039	-1.896**
Cumulative voting / representation (yes=1)	-0.0002	-0.110	-0.0019	-0.273
Oppressed minorities mechanism in place (=1)	-0.0212	-2.015**	-0.0462	-2.111**
% votes to call extraord. shareholders meeting	0.0068	0.012	0.0016	0.378
Pre-emptive rights for new issues (yes=1)	-0.0058	-0.567	-0.0035	-0.727
One share-one vote in corporate law (yes=1)	-0.0073	-1.245	-0.0044	-0.862
Approval to petition for reorganisation (yes=1)	-0.0057	-0.725	-0.0042	-0.672
No automatic stay on assets (=1)	0.0451	1.041	0.0087	0.850
Secured creditors 1st in liquidation (yes=1)	0.0062	0.729	0.0082	0.825
management does not stay in restructuring (=1)	0.0005	0.512	0.0041	0.983
% of secured creditors to approve restructuring	-0.0034	0.917	-0.0022	0.756
Rule of law (0 to 10)	0.0014	0.241	0.0007	0.426
Risk of contract repudiation (0-10)	-0.0061	-1.589	-0.0077	-1.645
Risk of expropriation (0-10)	0.0058	0.751	-0.0051	0.415
Accounting standards (0-100)	0.1140	1.857*	0.1363	1.955*
Corporate governance regime of target				
Accounting standards (0-100)	0.0947	2.013**	0.1084	2.114**
One share-one vote in corporate law (yes=1)	0.0134	1.892**	0.0089	1.936**
Bid characteristics				
Hostile acquisition (=1)	-0.0300	-2.4167***	-0.0344	-2.493***
Friendly acquisition (=1)	0.0141	1.251	0.0308	1.669*
Cash payment (=1)	-0.0085	-1.700*	-0.0073	-1.367
Bidder and target characteristics				
Target market-to-book ratio	-0.0075	-2.422***	-0.0088	-1.924*
Bidder diversification	-0.0135	-1.865*	-0.0102	-1.729*
Bidder and target: same industry	0.0837	1.667*	0.1178	1.314
M&A location				
Cross-border M&A (=1)	0.0094	1.688**	-0.0072	-0.378
Industries	Yes		Yes	
Years	Yes		Yes	
Observations	142		142	
R^2	0.368		0.340	
Adjusted R^2	0.222		0.196	
Signif. of F-value	<0.001		<0.001	

Note: This table shows OLS regressions of cumulative abnormal returns over different event windows for bidding firms. For a definition of the variables, see above. ***, ** and * stand for statistical significance at the 1%, 5% and 10% level, respectively.

Source: Own calculations.

PART III

9. Takeover Regulation in the European Union

This section begins by describing briefly the legislative history of the 13th Directive in the EU and its problems. In particular we examine the High Level Group's reform proposals that have influenced the European Commission and the recent debates about the design of takeover legislation. Finally, the last part summarises the draft takeover bids Directive.

9.1 Legislative history of the takeover bids Directive in the EU

The rapid integration of EU capital markets as a result of the euro has highlighted the remaining barriers to the realisation of a single capital market. The proposal for a takeover bids Directive is regarded as a crucial element of the EU policy to create a truly integrated financial services market and in 1999, it became part of the Financial Services Action Plan (FSAP), which seeks to promote the adoption of certain pieces of legislation in this area by 2005. The March 2000 Lisbon European Council reiterated that the takeover Directive is a crucial part in the economic strategy of improving the economic performance of European firms.

The efforts at harmonising European takeover law focus on three types of transactions: takeovers in general, mandatory bids, and certain types of squeeze-outs. The initial proposal for a takeover Directive[14] was a detailed document that specified required terms of the takeover bid. The proposal was seen by member states as too detailed and, moreover, an unwarranted intrusion into their domestic policy. As a result, the European Commission announced in the declaration to the Edinburgh European Council in December 1992 that it would revise the proposed Directive that was reconfirmed at the Essen European Council in December 1994. The Commission introduced a second proposal, changing it into a framework proposal based on the British City Code on Takeovers and Mergers, in February 1996.[15] In general, the Commission, through the second proposal, intended to introduce some general principles designed to guide regulatory efforts, while allowing for minor variations in the implementation of the principles by the competent authorities. The central elements of the 1996 proposal were the mandatory bid rule and the prohibition of frustrating actions by managers, the two provisions clearly reflected in the British City Code's approach to takeovers. While there was initial opposition to the second proposal, a common position was eventually agreed by the Council in June 2000.[16]

The text of the common position of the EU Council on the proposed takeover bids Directive was subsequently presented to the European Parliament for a second reading. The common position suffered a number of serious obstacles. A study by Klaus-Heiner Lehne (2000) identified a variety of problems with the common position, which led to the introduction of 20 proposed amendments. The amendments were designed to allow directors to enact defensive measures and a requirement to safeguard workforce levels after a change of control. Among the amendments were provisions designed to allow

[14] OJ C 64, 14.3.1989, p. 8, with explanatory memorandum, Suppl. 3/89 – Bull. EC.

[15] OJ No C 162, 6.6.1996, p. 5; with explanatory memorandum, COM(95) 655 final.

[16] OJ No C 23, 24.1.2001, p. 1.

directors to adopt poison pills and would have reduced the incentive for foreign firms to pursue corporate takeovers. As a consequence, a conciliation process was necessary, which led to an agreement regarding the adoption of a joint text, along with a promise that a Group of Experts would examine, as part of a review to modernise European company law, the problem of equitable price and squeeze-outs. When presented with the text on 4 July 2001, the European Parliament voted 273 for and 273 against the compromise text.

9.2 High Level Group of Company Law Experts

The failure to reach agreement on a common solution for takeover bids prompted the European Commission, in July 2001, to appoint a High Level Group of Company Experts,[17] chaired by Professor Jaap W. Winter, to examine the issues raised by the European Parliament and the EU's Council of Ministers during the last stage of negotiations on the common proposal for a takeover bid Directive. With respect to the High Level Group's mandate in relation to takeover bids, the group considered three main issues: 1) the creation of a level playing field for takeover bids; 2) the definition of an equitable price for a takeover bid; and 3) the introduction of squeeze-out and sell-out procedure in the context of takeover bids.

In its first report, the High Level Group of Company Law Experts undertook to scrutinise the relationship between the company law structures in member states and takeover bids. The HLG report recognises the contribution of a well developed securities market to the development of an integrated takeover market, but underlines the importance of Community interventions in specific company law mechanisms and structures to support the development of a level playing field for takeover bids. Against this background, the HLG report identifies two principles, shareholder decision-making and proportionality between risk-bearing capital and control, that are needed to inform the regulation of corporate acquisitions in Europe (Chapter 1, pp. 20-22). These principles, of course, have an impact only if they have been specified in binding legal rules. The HLG report found that the presence of differentiated voting rights, voting caps, golden shares, voting trusts, pyramid structures and circular and cross-shareholdings and other structures in the company law of member states are generally inconsistent with the two principles. Because the effect of these mechanisms is to make it more difficult for shareholders to oust incumbent management, the HLG believes that the Commission is justified to make use of the principles so as to ensure that takeover bids are not unduly frustrated or inhibited.[18] Thus, based on this argument, the HLG report undertakes to defend rules that regulate shareholder decision-making in the first and second stage of the takeover bid.

The HLG report endorsed Art. 9 in the common position stating that target boards should be prevented from taking any defensive measures to frustrate a hostile takeover bid after it has become known unless it has received shareholder approval at a general meeting and this approval may not be obtained until the offer is presented. The only

[17] Committee members include Jaap W. Winter, Jan Schans Christensen, José Maria Garrido Garcia, Klaus J. Hopt, Jonathan Rickford, Guido Rossi and Joëlle Simon along with Dominique Thienpont (Rapporteur) and Karel van Hulle (Secretariat).

[18] The HLG recommended also the improvement of disclosure requirements on such voting rights and structures (Chapter 1, pp. 25-26).

measure that target boards can take without authorisation by shareholders is to seek separate bids. But Art. 9 alone, however, does not ensure that the principle of proportionality between risk-bearing capital and control is adhered to once the takeover bid has been made public. The HLG report recognises that if prior to the bid the capital and control structures of the firm deviate from this principle, some target boards will use the structures to frustrate the takeover bid. Thus, application of the proportionality principle mandates, according to the HLG report, that a board should be allowed to take defensive action in response to an unsolicited offer only if authorised by a majority of votes exercised by holders of the proportionate majority of risk-bearing capital. From the perspective of the HLG report, the application of the proportionality principle together with the principles set forth in Art. 9 of the Directive provide a framework for determining whether a level playing field has been achieved.

Moreover, a level playing field can only be achieved, according to the HLG report, by introducing a 'break-through rule,' which is applied after the acquisition of 75% of the risk-bearing capital. Under the proposed break-through rule, if the acquiring firm acquires a level of 75% of the risk-bearing capital of the company, then he should be able to exercise a corresponding share of total votes and therefore take control of the company. The break-through rule itself involves two sub-rules: 1) provisions preventing the exercise of proportional voting rights (e.g. voting caps) should be overridden; and 2) provisions understood to limit exercise of the control of the internal affairs of the company (e.g., board composition) should be overridden. Under the proposed rule, there would be no need to distinguish between defensive measures held by public (e.g., golden shares) and private companies. Additionally, the break-through rule applies to the respective defensive measures generally, irrespective if they were adopted as pre-bid or post-bid devices. The core point is that a level playing field can be reached in the EU only if the proposed takeover rules ignore the prevalence of different classes of shares within the EU. The HLG report is clear in denying that compensation should be extended to the holders of special control rights.

The HLG report also sought to clarify the notion of equitable price under Art. 5 (1) of the proposed Directive. In short, the HLG report recommended a harmonised approach is necessary to allow offerors an effective and predictable way to determine the acquisition price for the target company.

Finally, the HLG report examined the approach to squeeze-outs of any shareholder who failed to tender their shares. Most member states allow for large stockholders to eliminate a public target company's minority shareholders by squeezing them out. In some member states, the squeeze-out provisions require that a shareholder control 90% or more of the company stock before it can buy out the remaining shareholders. The HLG report justifies a squeeze-out right on the grounds that: 1) the remaining minority shareholders create additional costs and risks for the majority shareholder; 2) there will be significant costs to provide a legally sufficient corporate governance regime for the minority shareholders; and 3) there is a worry about majority shareholders being potentially exploited by minority shareholders. Similar justifications were extended to rules on squeeze-out procedures. The HLG report proposed that squeeze-out and sell-out rights be applied on a sufficiently uniform basis within the EU. The HLG recommended three principles:

a) Member states should be allowed to require shareholder control of between 90% and 95% of the capital or 90% of acceptances before elimination of minority shareholders;

b) Member states should impose a fairness provision such that majority shareholders should pay a fair price (e.g., the takeover price) to the remaining shareholders; and

c) Member states should establish sell rules that allow all classes of minority shareholders a sell-out right if the majority shareholder acquires between 90% and 95% of the capital.

9.3 Proposed Directive on takeover bids

The European Commission presented on 2 October 2002 a new proposal for a Directive on takeover bids. The proposed Directive shares crucial features with the HLG report. Specifically, the proposed Directive provides for: 1) strict board neutrality rule on the part of the target board; a mandatory bid rule that ensures that an acquiring firm cannot obtain a controlling stake without making a controlling bid; 2) mini-break-through rules that stipulate that, during the period of acceptance of a bid, any restrictions on the transfer of securities contained in the articles of association and contractual arrangements (but not in national legislation) are not enforceable against the offeror; 3) a set of disclosure rules in which the offeror must announce his intention to make an offer and make public an offer document containing at least a minimum of information; and 4) 'squeeze-out' and 'sell-out' rules that would have to be implemented at a fair price.

The proposed Directive appears to endorse a hybrid shareholder choice approach to takeover regulation. The hybrid shareholder choice approach provides an efficiency justification for regulating certain pre-bid defences and recognises that not all defences can be subject to regulation (Arlen and Talley, 2003). Based on efficiency reasoning, proponents hold that a strict shareholder choice regime is not always welfare-enhancing, since managers can simply entrench themselves in another way by employing pre-bid defences, embedded in the firm's contractual arrangements, that allow incumbent managers to restrict the number of bids. In this regard, the Commission's endorsement of strict board neutrality and the adoption of mini-break-through rules (Art. 11(2)) would appear to confirm this suggestion.

Like the earlier draft, the proposed Directive met resistance from Germany and other member states on several substantive issues, particularly the break-through rule. In anticipation of the public hearing on 28 January 2003, the European Parliament Reporter surveyed the main problems posed by the Takeover Directive.[19] First of all, the Reporter noted that in most continental European countries multiple voting rights are permitted by law, but are banned in Germany. Consequently, companies that are not permitted to use multiple voting rights have less effective mechanisms than other member states to protect shareholders' interests against an aspiring bidder. This argument favours the adoption of the High Level Group's break-through rule so as to create a level playing field for takeovers. While the High Level Group's arguments favouring the introduction of a break-through did not recommend compensation for the

[19] European Parliament, Committee on Legal Affairs and the Internal Market (2002).

holders of multiple voting rights affected by the break-through rule, and the Commission overlooked the possibility of compensation for multiple voting rights, the Rapporteur argues that this general proposition would provide a straightforward solution to the problem. Finally, the proposed Directive adopts, in response to the HLG's criticism, a means for calculating an equitable price. The Rapporteur suggests that perhaps even a greater degree of harmonisation concerning the definition of the threshold giving control is necessary.

On 15 January 2003, the legal draftsman of the Committee on Economic and Monetary Affairs, Christopher Huhne, surveyed the proposed Directive and offered arguments favouring the adoption of the proposal by the Committee on Legal Affairs and the Internal Market. The following week, however, the European Parliament issued a report on the proposed Directive that claimed it is inconsistent not to ban multiple voting rights as takeover defences. The authors of the report offered a break-through remedy of 15%, which reflects the differences between the value of supervoting and limited voting shares across the EU. On 28 January 2003, the Committee on Legal Affairs and the Internal Market conducted a public hearing on the proposed Directive. At the public hearing, the proposed Directive was widely criticised by representatives from the Nordic countries and Germany, but support was voiced from experts from the United Kingdom, the Netherlands and other countries. The European Parliament's Experts advocated the application of the break-through provisions to multiple class arrangements and recommended that the bidder pay 'fair compensation' to the holders of shares broken through. In contrast, others provided testimony stating that even if a straightforward procedure does not exist for addressing the problems associated with introducing the break-through rule, a long transition period can be engineered to overcome most of the problems that would result from introducing the rule (see e.g. McCahery, 2003). Against the backdrop of rising opposition to the Commission's proposal, the plans for a compromise proposal emerged on 22 February 2003.[20] Aimed at overcoming German opposition, the compromise plan floated by Greece, the current holder of the EU's rotating presidency, would have met the level playing field objection by endorsing the adoption of the break-through rule along the lines of the High Level Group recommendation. The prospects for adoption of a revised proposed Directive are uncertain, but could be enhanced by the decision not to include French shares with multiple voting rights.

Nevertheless, there remains significant opposition from Nordic countries.[21] With the concerns of the Nordic countries and France in mind, the Committee on Economic and Monetary Affairs issued an opinion that considered, all things considered, whether 1) French dual-class shares should be included within the scope of the break-through rule; 2) existing dual-class and multiple-class shares should be subject to a grandfather clause; and 3) the optimal length of the transition period.[22] Finally, a key test for the proposed Directive is whether the European Parliament will endorse the main recommendations of the Commission. Notably, some Members of the European

[20] Francesco Guerrera and Christopher Brown-Humes, "EU may ban 'poison pill' bid defences", *Financial Times*, 22/23 February 2003.

[21] Jesper Lau Hansen, 'Vote differentiation is no deterrent to takeovers', Letter to the *Financial Times*, 26 February 2003.

[22] 'Studie naar diverse opties overnamewet', *Financiële Dagblad*, 18 March 2003.

Parliament have recently proposed a number of amendments to the proposed Directive, many of which would require substantial alteration to the Commission's proposal (i.e. adoption of the break-through provision, sell-out rights in the case of multiple voting rights and a reciprocity clause that allows member states to block takeover bids from offerors from a third country).[23] It remains an open question which of the proposed amendments will be so influential that they will be incorporated into the proposed Directive. These considerations aside, the German-UK compromise heightens the probability that the proposed Directive may well be adopted by the European Parliament and Council of Europe and fully implemented by 2010. In the following sections, we analyse the core components of the proposed Directive.

10. The Market for Corporate Control and Tender Offers

To provide a context for the discussion of the proposed Directive, we briefly describe how the tender offer process functions. The market for corporate control is viewed as a mechanism to correct managerial failure. The basic idea is that hostile takeovers are an important corporate governance device because they target poorly performing firms and replace their poorly performing management teams with new managers who are committed to the maximisation of shareholder value. It is important to note that the more concentrated ownership structure combined with the technical and legal barriers makes hostile takeovers difficult, if not impossible, to conclude successfully in continental Europe.

Besides these barriers, a number of economists have shown that the efficiency of the takeover mechanism also tends to contribute to the decrease in the probability of hostile acquisitions. For example, Grossman and Hart (1980) have shown that a striking feature of the takeover market is that the 'free-rider' problem makes it possible for incumbent to recover the costs of the bid (e.g. information and search costs). If we assume that the target has widely dispersed ownership, a free-rider problem occurs when no individual shareholder affects the success of the tender offer. There are a number of schemes that can overcome the free-rider problem. For example, Grossman and Hart argue that dilution tactics, such as a freeze-out at a price below the target's full value after the completion of the takeover, will ensure that the shareholders will be willing to tender at a price where the bidder achieves a profit. In the Grossman and Hart model, the bidder determines the dilution mechanism *ex post*, which they constrain to be above the stand-alone value of the target company.

The literature has identified other mechanisms besides dilution to attempt to overcome the free-rider problem (Bebchuk, 1994; Burkart, Gromb and Panunzi, 1998). For instance, Yarrow (1985) found that, if there are no private benefits available to the bidder, a squeeze right to the bidder at a price below the value of the merged company will provide the dilution necessary to provide the bidder's costs. Acquiring an initial toehold in the target company will allow the bidder to retain some of the public benefits of the eventual takeover gains (Shleifer and Vishny, 1986, Hirshleifer and Titman, 1990). It is necessary at the time of the toehold acquisition that the market does not anticipate that a takeover bid is imminent.

[23] European Parliament, Draft Report on the proposal for a European Parliament and Council directive on takeover bids (COM(2002) 534 –C5-0481/2002 –2000/0240(COD)), 11 March 2003.

The free-rider problem, however, does not arise if there are sufficient private benefits of control left in the firm for the majority shareholder to finance the bid. Also, there is no free-rider problem when shareholders are uncertain about the success of the proposed bid. Even if the bid price is below the stand-alone value of the target firm, shareholders may be under pressure to tender. Bebchuk (1985) stresses that the simultaneous decision-making of dispersed shareholders whether to tender can result in tendering although shareholders are aware of the bid price being below the stand-alone value. Shareholders would decide to tender only because they expect other shareholders to tender. Naturally, controlling shareholders are never under pressure to tender.

The above argumentation shows that in order to increase the flow of takeover bids, it is, therefore, necessary that minority shareholders do not participate in the full value of the firm. It is worth pointing out that takeover bids have dual effects. Indeed, two views show up prominently when discussing the efficiency of takeover bids. On the one side stand supporters of the market for corporate control, many of whom argue that takeovers create value improvements by exploiting buyer and seller synergies. On the opposite side stand those who are inclined to point to the higher number value-decreasing bids and the high costs associated with takeovers that are primarily motivated by managerial compensation and the expropriation of the target firm's stakeholders. Bebchuk (1994) argues that one of the criteria of good takeover regulation is to ensure *ex-post* efficiency. *Ex-post* efficiency is defined as the optimal reallocation of existing assets.

There is a second efficiency issue. The amount of assets in an economy is not given, but depends on investment decisions that are made in firms, which are usually delegated to managers. In this regard, takeovers are understood as an incentive mechanism for management to select high net present-value projects in order to ensure that the funds shareholders entrust to them achieve the highest rate of return.

Thus, the aim of takeover regulation must balance introducing rules that induce bidders to launch a bid and guarantee that small shareholders will be willing to sell their shares when it is efficient to do so. The available evidence suggests that policy-makers must attempt to balance the trade-offs between promoting policies that make takeovers less costly and thus produce more bids and encourage equal treatment and shareholder protection (Berglöf and Burkart, 2002; Bergstrom, Hogfeldt and Molin, 1997). A recurrent theme in EU takeover policy discussions concerns the balance that policy-makers must strike between protecting shareholders from the effects of managerial opportunism, represented in the form of pre- and post-bid defences, and deferring to the judgement of management. Against this background, the next section will examine the role of the mandatory bid rule, as set forth in the proposed Directive, to ensure efficient takeovers.

10.1 Mandatory bid rule

Art. 5 of the proposed Directive is designed to trigger a mandatory bid when the bidder together with persons acting in concert with him acquires a certain percentage of voting rights in the company that confers on him the control of the target. The member states should determine both the percentage of voting rights conferring control and the method

of its calculation.[24] The member states should also adopt rules on information and particulars about the consideration to be offered.[25]

Under the proposal of the HLG, the mandatory bid rule is of crucial importance in protecting minority shareholders from the abuse of a majority blockholder. It provides the minority shareholders with adequate and fair terms of exit and eliminates any room for tendering in partial bids at less favourable prices.

The notion of the 'equitable price' is the key in the mandatory bid context proposed by the High Level Group and the Directive. Though the HLG does not give an exact definition of an equitable price, they argue that any definition should achieve adequate balance between flexibility in achieving minority protection and predictability of costs in the mandatory bid context.

The HLG argues that the introduction of harmonised approach will allow '[offerors] to predict and ideally to determine the equitable price they will have to pay in a mandatory bid.'[26] The consideration must be offered at the highest price paid for the shares of the relevant class in a period between six to twelve months prior to the bid in market and over-the-counter transactions either in cash or in liquid securities.[27]

Based on the HLG recommendation, the highest price paid allows minority shareholders to obtain the benefits of any control premium to be paid on the one hand, while allowing the bidder to predict his costs on the other hand. The HLG also acknowledges that the highest price rule may not achieve adequate treatment of the minority shareholders under certain circumstances. Following the recommendations of the HLG, the Directive adopts the highest price rule. It allows member states to grant exemptions to the highest price rule under certain circumstances.

10.2 Implications of the mandatory bid rule

The strongest argument in favour of the mandatory bid rule is that it provides a fair exit mechanism for shareholders who do not tender in connection with a takeover bid. The rule provides minority shareholders with a welfare-increasing regime by giving them an unconditional put option on their shareholdings. It also decreases market uncertainty, which enables the bidder and shareholders to capitalise on the cost of the bid and on the cost of exit, respectively.

The mandatory bid rule can be broken down into two key components: 1) a full bid must be made; and 2) the consideration offered in the full bid. Requiring full bids alone constitutes a major form of protection for minority shareholders. Burkart (1999) argues that a mandatory bid – which entails the preclusion of partial bids – protects minority shareholders even if the bidder is free to set the price of the bid. Thus, by restricting partial bids it is no longer possible to offer two prices for the front and back end of the dispersed shareholder base. As a consequence, the bidder will not propose a bid below the stock market price at the time of the bid.

[24] See §§ 5(1), 5(3) of the Directive.

[25] See § 6(3) of the Directive.

[26] See Recommendation II.1 of the HLG report.

[27] See Recommendation II.2 of the HLG report, See § 5(5) of the Directive.

However, the picture is altered if blockholders are introduced. Thus, if the bidder must obtain control from a blockholder, the equitable price rule will have an impact (Bebchuk, 1994). Under the assumption that the blockholder has access to private benefits of control, the blockholder enjoys a disproportionately large segment of the company's stand-alone value. To transfer control, the incumbent blockholder demands compensation for the loss of enjoyment of the private benefits of control. If all shareholders must be treated alike (*viz*. shareholders of the same class), the blockholder's share will be proportionate to the value offered in the takeover. For the incumbent controlling shareholder, the proportionate value of the takeover can be less than the disproportionate share of the stand-alone firm value. In this case, the takeover may fail even if the takeover were to create value. Based on the foregoing, the implication is that a mandatory bid rule decreases the number of takeovers. It avoids value-decreasing takeovers but may preclude some value-increasing takeovers. The *ex-post* efficient regulation would be designed to avoid all value-decreasing takeovers but encourage all value-increasing takeovers.

The proposed Directive prescribes that the price to be offered in the mandatory bid does not allow any discounts to previous block trades. Hence, there is a danger that value-increasing takeovers are foregone. Thus, the question is how to describe an *ex-post* efficient pricing rule. While a prescribed percentage discount on previous block trades may permit more takeovers to proceed, such a prescription may nevertheless be too coarse-grained given the variance of private benefits across firms.

The pure form of the equal opportunity rule would equal the mandatory bid rule price with respect of the private sale of control. Other legal arrangements prescribe that the equal opportunity price should be related to the stock market price in a specified period prior to the bid. For example, the voluntary German Takeover Code in place before 2002 specified the highest stock market price in the three months prior to the bid as the equal opportunity price. This rule implies that the stock market price does not include any private benefits unless they are included in a subsequent squeeze-out procedure. The stock market price rule can be seen as guaranteeing all shareholders the stand-alone value of the firm. This tends to imply a higher takeover incidence than under the proposed rule.

Taking into account *ex ante* efficiency involves more trade-offs. On the one hand, the threat of takeovers is seen as an incentive mechanism for the incumbent managers. Since monitoring of management is costly, there must be a compensation for the shareholder that engages in monitoring. One of the ways to compensate the shareholder is to give him private benefits of control which can help to overcome the free-riding problem. In this view, blockholdings are thus beneficial from an *ex ante* perspective, because they encourage management to increase firm value. On the other hand, blockholders have an incentive to collude with the management. Thus private benefits are seen to be reducing firm value. Hence, takeovers under a mandatory bid rule function to distribute some of the future private benefits of the bidder to the target shareholders. From the viewpoint of allocative efficiency, this mechanism is valuable since the funds distributed may be reinvested by the shareholders in other projects. However, the more demanding the equitable price rule is, the lower the takeover threat with, perhaps, adverse effects on incumbent management's incentives.

While the mandatory bid – with an appropriate equal opportunity price rule – can be regarded as a safeguard against value-decreasing takeovers, when there are private benefits available to some shareholders, the discussion on the break-through rule indicates that such a safeguard is not perceived as sufficient.

The proposed Directive leaves the definition of the trigger threshold for the mandatory bid to member states. Thus, not all aspects of the mandatory bid are regulated by harmonisation. The idea is that effective control thresholds depend on national company law. To be sure, this is a sensible approach. In this regard, diversity is warranted as long as national company law differs. Since there are costs in terms of precluded value-enhancing takeovers, a harmonisation of the equitable price rule precludes regulatory competition to minimise this cost. On the other hand, regulatory competition may not be strong if national equitable price rules would be complicated. However, it appears that regulators could in principle design simple rules that foreign shareholders (or 'the market') should be able to understand. Thus, shareholders from different jurisdictions would not benefit from the introduction of a harmonised rule. To be sure, the results of cost-benefit analysis of the proposed rule will depend on how effective it is in reducing value-increasing takeovers.

10.3 The break-through rule

As noted above, the HLG recommended in its January 2002 report a novel idea, called the break-through rule, designed to foster the incidence of takeovers in the EU. The proposal is intended to eliminate a wide variety of corporate governance arrangements that can have the effect of reducing the threat of takeovers. These pre-bid defences are viewed as significant impediments to the emergence of a well functioning cross-border takeover market in the EU. Thus, by stressing the need to create a transnational takeover market, the High Level Group advocates a policy designed to eliminate the control structures that impede takeovers – even if they have an impact on corporate governance beyond the specific context of a takeover bid – because they create barriers to the creation of an integrated market for corporate control and a mature capital market in Europe.

The HLG argues that a bidder should be permitted, immediately upon the acquisition of 75% of cash flow rights, or any relevant threshold not higher than 75% set forth by the member states, to remove any arrangements that deviate from a one-share/one-vote structure, although the HLG does not explicitly declare one-share/one-vote as a general principle. Having acquired any relevant threshold of cash flow rights, the bidder will be allowed to convene a general meeting of shareholders on short notice and impose one-share/one-vote. Any mechanisms or structures that deviate from the principles of shareholder decision-making and proportionality between risk-bearing and control will be broken through. This implies that the very concept of ownership is redefined in the takeover context. Cash flow claimants become not only residual claimants of the company but also residual decision-makers. So, for example, upon reaching the required threshold, the bidder will be permitted to: 1) amend the articles of association and other constitutional documents; 2) remove any pre-bid takeover defences approved by shareholders; 3) remove voting caps and differential voting rights; 4) remove provisions denying voting rights; 5) remove voting rights on non-risk bearing capital; 6) appoint, suspend, and dismiss the board members other than those appointed by third parties; 7)

determine the composition of the board; 8) remove any staggered and/or fixed period provisions; and 9) override special control rights attached to golden shares.

The HLG provides a list of company charter devices that lead to deviations from a one-share/one-vote structure. However, it would be too great a task to review them one by one. The proposed Directive considers only some of them in Art. 9. The device that is receiving most attention in the political debate is the multiple voting right share structure. For this reason, the break-through rule will be subsequently analysed in the light of such a structure. Finally, we will move on to discuss the empirical evidence on the use of dual- and multiple-class shares among EU member states.

The effect of the break-through rule is to transform a bid on a company, which is held by a blockholder, into a bid with dispersed ownership. As conceptualised, it seems to have been implicitly assumed that the break-through rule would be applied only when the board of the target company formally rejects the takeover bid. It is clear, however, that the bidder may decide to pursue the break-through route of taking over a company even if the incumbent controlling shareholder would be prepared to negotiate on a transfer of control. Berglöf and Burkart (2002) make this argument in their analysis of the break-through rule, which is detailed below.

10.4 Implications of the break-through rule

In the first instance, the designers of the break-through rule endorse the statement that no single form of corporate charter is optimal. Yet, only in the context of takeovers would it appear that one type of corporate charter arrangement is preferred, namely a one-share/one-vote structure. In this regard, increasing takeover incidence has become a goal in itself that will eventually determine the contents of a firm's corporate charter.

Proponents of the break-through rule argue that a dual-class regime lowers the probability of a takeover and reduces, in turn, the incentives of managers to undertake value-maximising projects for the benefit of the firm's residual investors. In contrast, supporters of dual-class stock argue that dual-class shares produce a number of desirable effects including: 1) protection against shareholder opportunism and misjudgements due lack of information; 2) protection against predatory bid tactics; 3) reduction of agency problems; and 4) compensation for greater firm-specific risk.

Multiple voting rights are but one form of private contracting in the corporate charter. They are the outcome of prior shareholder decisions. Voting shareholders decided to issue them, and new shareholders agreed to purchase them. To override by regulation investment decisions that were made by shareholders in full knowledge of the rights attached to the investment securities necessitates an analysis of whether there is a gain in efficiency to be expected from such regulatory measures.

A rigorous analytical framework of (non)optimality conditions of the one-share/one-vote rule in the takeover context is mainly set by pioneering works of Grossman and Hart (1988) and Harris and Raviv (1988). Although the proposed settings differ in some respects, the authors' general conclusion is that the distribution of voting rights affects the value of the firm and under qualifying conditions (almost always), the one-share/one-vote rule is not value-maximising. There will be wealth-increasing deviations from the one-share/one-vote rule.

Let's look at dual class from the perspective of takeovers. The consequences of dual class viewed from a takeover defence perspective are well documented in Coates (2001). Indeed, a number of empirical studies point out that anti-takeover provisions merely influence the takeover probability and the premium of the target firm (see Hannes, 2002). Moreover, most empirical studies of takeover defences have found that these defences have little or no impact on bid outcomes (see Brickley et al., 1994). This is consistent with practising lawyers' positions about takeover defences not having much harm and mattering only at the margins.[28]

However, to take account of the arguments propounded by the supporters of dual-class shares, one is advised to look at the whole picture of corporate governance, and not merely at the event of takeovers. We have seen earlier in Section 4 that dual-class shares divert a disproportionate amount of the company value to insiders. However, these studies for the most part do not directly address the issue of how company value itself is impacted by the deviations from the one-share/one-vote rule. A few costs of capital studies, as outlined above, show that strong investor protection correlates with lower costs of firm capital. The investor protection variable is a composite index in which the dual-class criterion is but one factor that is measured in a cross-section of countries. From these studies it is difficult to ascertain what is the marginal contribution of a dual-class structure to the value of the firm.

In terms of trying to isolate the firm value effects of dual-class shares, Grullon and Kanatas (2001) find that insiders in multiple-class firms select their capital structure to defend against takeover threats. Using the unadjusted and industry-adjusted market-to-book ratio to assess how this behaviour impacts firm value, they find that the average adjusted market-to-book value is ratio positive and significant at the 1% level, whereas the medium adjusted book-to-value ratio is negative and marginally significant at the 10% level. Like previous studies, Grullon and Kanatas confirm that the company value consequences of dual-class structures is ambiguous (see also Morck, Shleifer and Vishny, 1988). They find evidence that the returns on assets of dual-class firms are significantly higher than the industry peers.

Unlike the US, there are few empirical studies in Europe that have sought to analyse the wealth effects of pre-bid defences by shareholders. It is worth noting that some new studies are beginning to appear that seek to supply evidence about the effects of defences on bids. For example, a recent paper by Rose (2002) investigates the performance of Danish firms that adopted dual-class shares for the period between 1995 and 1999. Using Tobin's Q, share return, return on assets and return on equity, he shows that unprotected firms do not outperform firms protected by dual-class stock. The challenge is to explain this result. Rose offers a number of reasons why protected firms perform so well. Rose argues that other corporate governance mechanisms, including blockholder monitoring, appear to supply sufficient incentives to managers to persuade them to limit their opportunism and to invest in value-maximising projects.

Based on the above, the efficiency implications of dual-class stock are inconclusive. Studies on European firms are rare and often too aggregated to provide a detailed picture about their effects on corporate performance. However, what the studies do

[28] See Bebchuk, Coates and Subramian (2002), who analyse empirical evidence on the effect of takeover defences.

indicate is that the market is able to differentiate between corporate governance arrangements. Recent anecdotal evidence about the status of multiple voting-class shares indicates that capital-cost considerations play an increasingly important role in the design of share class structures. For example, Ericsson is considering, in response to a recent decline in share performance, replacing its B-class shares in order to lower its cost of raising new capital.

Berglöf and Burkart (2002) observe that the break-through rule is inconsistent with the mandatory bid rule. This is due to the fact that the break-through rule is available as an option to bidders to bypass negotiations for private transfers of control with the incumbent management. As we have seen above, only in case of such negotiations will the mandatory bid rule lead to participation of the minority shareholders in the private benefits available to the controlling shareholder.

The effect of the break-through rule is to transform a bid for a company with a concentrated ownership structure into a dispersed bid. If the incumbent controlling shareholders have access to sufficient funds to launch a counterbid, the bidder will in turn be forced to bid at least as much as the incumbent shareholder. The maximum bid of the incumbent shareholder will include the sum total of his private benefits and the stock market valuation of the target firm. But, if the incumbent is financially constrained, the bidder will not offer more than the public value of the target firm after the completion of the takeover. The free-rider problem that arises in bids with widely dispersed ownership can be overcome by the private benefits available to the bidder. Hence to use the break-through rule, as a means of acquiring control, is the dominating strategy for the bidder even if the incumbent management is in principle willing to enter into negotiations.

In legal terms, the break-through rule leads to the acquisition of control not by passing a threshold on voting-share holdings but by effecting a change in a corporate charter. It is, however, unclear whether such a control transfer would trigger a mandatory bid. If it did not trigger a bid, then the problems associated with two-tier takeover bids would be reintroduced.

At the same time, under the assumption that the incumbent is not willing to tender, the break-through rule does not open up the possibility of effecting a squeeze-out to the new controlling shareholder. Another important implication of the break-through rule is that it could alter the structures of ownership and concentration of voting rights. For example, Bebchuk and Hart (2002) predict that the break-through rule might induce firms – particularly new firms – to substitute a dual-class structure with a pyramiding structure. Such a step may in turn give rise, among other things, to problems related to monitoring, managerial incentives and liquidity.

10.5 Compensation

This raises the issue how to compensate those shareholders that are expected to lose from the introduction of the break-through rule. Whilst this issue was not addressed in the proposed Directive, it has been discussed in a recent study issued by the European Parliament, which favoured the adoption of a fair compensation procedure. Proposals based on average European premiums for voting rights appear to suggest that in the event of a takeover bid, all outstanding shares would have the same voting rights. Thus if the takeover were to proceed, the bidder would extend to voting shareholders an offer

that is x% higher than to non-voting shareholders. As a value for x, 15% has been proposed. Given the importance of national circumstances in the determination of the premium, this (and any other) figure would be largely arbitrary. Moreover, imposing such a figure would change the relative share price. Its proponents overlook the fact that this rule reverses causality: The compensation rule would determine the voting premium. The likely effect is that the voting premium would move towards 15% for all countries. A compensation scheme, derived from data equalising jurisdictions, does not solve the compensation issue in an appropriate way.

Interestingly, it is important to note that there are other schemes that can be used to compensate the holders of dual- and multiple-class shares. The schemes fall into three categories: a mandatory level of compensation, independent expert valuation and market-based compensation schemes (which may involve expert valuation as a remedy). We turn initially to discuss mandatory schemes. The HLG report explicitly recommended that the bidder should not be required to offer compensation. Advocates note that this is a simple rule that avoids appraisal proceedings and other costly legal proceedings. By the same token, this rule serves a legitimate public policy concern since it would help create a 'level playing field' in the sense that no compensation is paid under any circumstance. Some commentators, however, note that the mandatory rule exposes regulators to demands for compensation (see Zöllner and Noack, 1991).

There is also an extensive body of German literature concerning the evaluation of compensation in appraisal proceedings involving parent-subsidiary contracts and cases in which companies have abandoned their multiple voting shares. In this context, courts have employed a range of appraisal methods. In assessing the effectiveness of these methods, it is clear that courts have experienced considerable difficulty in establishing the value of additional voting rights when using appraisal methods that employ the concept of firm 'intrinsic value.' Hecker (2000) describes the method commonly used in Germany as based on free cash flows. This method involves a forecast of returns from the assets of the company. After making the forecast, it is compared to the liquidation value of the company, which also takes non-substantive business assets into account. The discount factor for future returns is derived from the subjective judgement by the accountant.[29] Hecker (2000) finds the application of the accounting methods to be arbitrary to a large degree.[30] Since the estimate of the reinvestment rates necessary to maintain the substance would allow significant subjective judgement of the accountants, it would, therefore, be difficult to separate substantive from non-substantive business assets. Even when the business strategy is taken as given, the cash flow forecasts can differ in how uncertainty is taken into account. Finally, there is the problem of determining the appropriate discount rate. In the valuation of profits method, the risk-free rate of return is augmented by the accountant's subjective evaluation of the risk premium (the compensation of the risk-averse investor for giving money to an uncertain project). Recognition that there is ample space for personal judgement is evidenced by the large differences between the initial expert studies and those commissioned in a subsequent judicial review, as shown by Hecker (2000).

[29] German accounting practice has recently turning to the discounted cash flow method (DCF), where the discount rate is derived from models built from capital market theory, which give a market valuation of the risk premium.

[30] Her study contained a sample of 16 compensation cases.

Similarly, Hering and Olbrich (2001a) analyse a scheme based on the net present value of future cash flows and other considerations. A key element in their approach is that claim that compensation should be denied to holders of multiple voting rights who are not *de facto* controlling shareholders. The argument favouring controlling shareholders is clearly unpersuasive. In other words, even if a large shareholder does not control the firm on his own terms, he could offer to sell his block to another large shareholder, who would as a consequence take control of the firm. It is important to note that the non-controlling blockholder would be in a strong position to bargain *ex ante* over the price of his shares. Moreover, they argue that a majority shareholder should only obtain compensation in those circumstance, after conversion, where the intrinsic firm value has decreased. This may involve comparing business strategies that were altered in conjunction with the cessation of the multiple voting rights. Since the determination of firm value is forward-looking, this is likely to entail significant accounting judgement about which changes in the business strategy should be pursued. Interestingly, an entrepreneur would not be entitled normally to receive compensation for his multiple-class shares unless it was determined that he is a 'good' entrepreneur.

One possible implication is that the determination of compensation that employs the 'intrinsic value' standard may well lead sometimes to an inconsistent outcome, due to the persistence of a number of loopholes, *viz*., the uncertainty about future cash flows and the determination of the appropriate discount rate. With respect to independent expert valuations, there may be some question whether the procedural techniques are capable of rigorous scrutiny. Moreover, these methods effectively omit any private values of control associated with operating the company. Indeed, it would a daunting task to attempt to separate the private benefits of control from the going concern value of the company by these methods. In the context of judicial investigation of a squeeze-out, experts will attempt to establish the total firm value in order to entitle the exiting shareholders to a share of it. With respect to valuations of multiple voting rights, experts will, in contrast, attempt to determine the value of additional voting rights, relative to the value of shares of other groups of shareholders.

It is interesting to review the terms of analysis that the 5th Chamber for Commercial Matters (Munich) employed to evaluate the value of multiple vote shares of the Siemens AG.[31] In that case, the court based its decision on a geometric mean of the relative price differences between common stock and preferred stock for a sample of German publicly listed companies over a period of 12 years prior to the conversion. In addition, the court adjusted its calculations by considering special factors because the compensation to be found was not for preferred stock but for multiple-class stock with differing legal entitlements. For example, a discount for name shares was applied, and some contractual arrangements were priced, while others were not. In total, an additional vote was found to be worth €0.70, which was multiplied by the number of additional votes of multiple voting shares. Once having completed the process, the holders were entitled to receive compensation of approximately €32 million.[32]

[31] The history of the multiple voting shares of Siemens is described in an extended form in the next subsection.

[32] Landgericht München (2002). The Higher Regional Court of Bavaria declared this decision void.

10.6 A sell-out right?

We now turn to the idea to couple compensation with a 'sell-out right.' It was proposed that 'a sell-out right would be given to the holders of multiple voting rights based on a fair price presumption.' Under this presumption, compensation would be regarded as equitable if it corresponded to the highest price paid by the bidder in a pre-specified period before the break-through. Obviously, this presumes that the bidder had to purchase some of the multiple voting shares either on the market or in a private negotiation. However, the number of free-floating multiple voting shares is probably quite small as most are held in blocks. It should be apparent that low levels of liquidity might depress the share price even below that of single voting shares that are widely held. Analysis of the role of the bidder suggests that if all multiple-class shares were held by a blockholder, the bidder will only acquire multiple class shares if they are necessary to reach the break-through capital threshold. However, in this case the break-through rule would be useless since the bidder would be required to enter into private negotiations with the incumbent controlling shareholder. In our view, it would appear that, given the control structures prevailing in continental Europe, the fair price presumption would result in compensation levels below the price of single voting shares.

10.7 Evidence of stock class conversions

As noted in previous sections, a multiple-class capital structure may be socially efficient for small, family-held firms. While we do not expect that large companies with significant free cash flows and a controlling multiple-class shareholder will become involved immediately to undertake changes to their share structure, the prospects of financial distress may provide sufficient incentives to induce management to respond to immediately. Analyses of case studies from Germany and Israel provide important insights into the benefits and costs of stock class conversions.

Hauser and Lauterbach (2000) studied Israeli stock unifications between 1990 and 1996. In 1989, 40% (104 of 260) publicly traded firms at the Tel Aviv Stock Exchange (TASE) had outstanding dual-class shares. Yet, after the TASE – together with the Israeli Securities Authority – banned the new issue of inferior class stocks in January 1990, more than 70 firms decided to unify their dual-class stocks. Hauser and Lauterbach investigate 67 unifications from 1990-96, where compensation was paid (if at all) in the form of additional shares. They found that only in two unification processes did the majority shareholders surrender their controlling position. On average, they found that the price for 1% of voting power was about 0.1% of a firm's equity. Characteristics such as size, leverage and profitability are not significantly different between compensating and non-compensating firms, but they differ most dramatically in their governance structure. The majority blockholder in firms that provide compensation owns a higher fraction of superior stock and a lower fraction of inferior stocks. Hauser and Lauterbach's findings are consistent with the hypothesis that majority blockholders dominate the unification process and especially determine the compensation scheme. Not surprisingly the compensation decreases with institutional holdings and increases with the fraction of the vote lost by the majority blockholder. The authors find, moreover, that the average share of majority holders in the market

value of firm equity does not change significantly after unification and that blockholders tend to avoid the expropriation of minority shareholders' rents.

In considering this question, it is important to note that there have been a number of unifications of different share classes in German firms. In 1998, a new regulation[33] was implemented in Germany that was designed to abolish multiple voting shares. The law provides for two mechanisms that would ban the multiple voting rights. First, the general assembly may propose the cessation of these rights, at the initiative of any shareholder. The holders of multiple voting rights are excluded from the vote. Second, the multiple voting rights are outlawed from 1 June 2003. In both cases, multiple voting right holders must be offered compensation that takes into account the particular value of the multiple voting right. If multiple voting rights are abolished by the general assembly, then it is the general assembly that determines the level of compensation. In the second case, it is effectively the board that has the power to determine the level of compensation. Both alternatives are open to judicial review. Any compensation offered depends on the circumstances under which it is determined. In any event, it is necessary that the company's shareholders decide on the compensation. However, if the shareholders are unable to agree on a compensation scheme, it will be left to the judicial process to resolve.

Siemens AG is an interesting case study. It held a general assembly in February 1999. The assembly voted for an abolition of the special class of shares, denying appropriate compensation for the loss in control power. In response, the trust representing the Siemens family sued for compensation at the 5th Chamber for Commercial Matters (Munich). In October 2001, as reported above, the Court determined that the additional votes were worth €0.70 each. As a result, the holders of multiple voting shares were awarded a total compensation of approximately €32 million. [34] In July 2002, the Higher Regional Court of Bavaria reversed the lower court's decision, holding that it was not safe to conclude that the additional voting rights have a positive value.

The next case involved RWE. The company, which was founded as a public utility in 1905, has relied on communities as their main investors. After the IPO in 1922, multiple-class shares were issued to the communities. In February 1998, the general assembly decided to abolish these special shares with a compensation of approximately €600 million. Whilst the owner of the multiple voting shares originally asked for €100 billion, the amount was reduced substantially during their negotiations with the board of directors.[35]

Similarly, VEW, which is another public utility, decided to unify their share classes in mid-1999 and offered compensation of €9 for each additional vote. The calculation was based on the price differences of 29 companies between 1997 and 1998, adjusted to the price level of VEW shares and corrected by some 'special factors'. Having reviewed these cases, it is worth pointing out that while Siemens and VEW clearly acted in

[33] Art. 11 of *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* (KonTraG – Company Law for Control and Transparency).

[34] Landgericht München (2002).

[35] Hering and Olbrich (2001b,c). At the official investor relationship site of RWE, the compensation is not mentioned.

response to regulatory changes, RWE abolished multiple votes prior to the enforcement of the law.

It is noteworthy that firms have made arrangements to alter their share structures in response to pressures emanating from the Deutsche Börse, which changed the rules for calculating its DAX and MDAX indices in June 2002. By permitting only the free-floating shares of one class for a company's weight in the index, firms with multiple-class structures saw their weight decrease in the index. As a consequence, large investment funds dropped their stocks. Since 2000, most of the major German companies have unified their preference shares with the common shares. Companies have employed a number of techniques. For instance, SAP and Südzucker AG used the equalisation of dividends as the only measure of compensation. Before the conversion, the superior voting shares of SAP were traded with a negative premium. The company was controlled by a group of founders who held 63% of the votes. After a complete conversion, this share decreased to 39%. Prior to conversion, Südzucker AG was controlled by three groups: SVGZ[36] (60%), Deutsche Bank (13%) and an Austrian consortium (6%). As of January 2003, SVGZ controlled 56%[37] and a new blockholder ZSG (NL) holds 10% of the votes. The free float has increased to 34%, but nevertheless a single block holder controls the firm. Interestingly, firms such as MAN Group and Metro decided to convert in a 1-to-1 ratio at a cash disbursement for the holder of inferior voting rights to be received by the company. In the case of MAN, the payment was made at €3.30, which corresponds approximately to 2/3 of the 3-month average price difference. At Metro, the conversion was at a cost of €11.60. There are only a few companies on the DAX, namely Volkswagen (VW), Bayrische Motorenwerke (BMW), Fresenius Medical Care and Henkel, that have preference shares outstanding. With the exception of Henkel, they have chosen to list the free float of common shares in the index.

10.8 Conclusions: The break-through rule and compensation

We have outlined that the evidence on efficiency implications of dual-class shares is inconclusive. Moreover, we have argued that the market is able to attach different prices to competing corporate governance arrangements. Naturally a question arises about the benefits and costs of mandating European legislation on corporate arrangements that can have the effect of frustrating takeover bids. Some arrangements impact directly on corporate governance beyond the event of takeovers. This general impact may also depend on the national legislative context. It may be impossible to determine whether the costs of losing diversity outweigh the benefits attributed to the break-through rule. Could regulatory competition led to the introduction of the most efficient rule? As discussed above, such a projection depends on how effectively investors can evaluate the consequences of a particular corporate law rule on firm value. To be sure, not all arrangements that are classified as pre-bid defences are equally transparent to investors. For example, the Dutch foundation model may be insufficiently transparent in its effects to foreigners. In contrast, the relative number of shares and votes in different classes may be more easily ascertained. Nonetheless, their impact on the effectiveness of

[36] Süddeutschen Zuckerrübenverwertungsgenossenschaft.

[37] Owner or hold in trust for another group.

control will depend on country-specific factors, which, as we have seen, give an inconclusive picture.

Given these trade-offs, we find it difficult to make a clear-cut case in favour of an across-the-board elimination of corporate governance arrangements that can have the effect of frustrating takeover bids. Despite these considerations, the political process has isolated some corporate governance arrangements from the checklist of arrangements purportedly having the effect of frustrating takeover bids to be subject to a mandatory European break-through regulation.

Nonetheless, our analysis suggests that should the EU decide to adopt the break-through rule, we recommend grandfathering the existing dual- and multiple-class shares for a significantly long period of time. We believe that this position has the advantage that the compensation takes place at company level and occurs only when the company itself decides to unify its share structure. If anything, we could expect that compensation might not occur or would occur at very low levels. From the perspective of companies, this position has the advantage that companies would have the flexibility to choose at least from a wide variety of alternatives, including the repurchase of their inferior voting shares, the allocation of additional shares to the formerly superior class, or an issue of a new single class share combined with a purchase right adjusted with a compensation in cash for the inferior shareholders.

While protecting the existing stock of dual- and multiple-class shares may limit in the near term convergence towards the one-share/one-vote structure, it should provide an indirect mechanism to achieve this result. Indeed, if all new firms have *de facto* a one-share/one-vote structure, an incumbent company with multiple classes may look 'old fashioned'. Shareholders can easily identify every company that has retained multiple classes (or indeed preferred stock). Thus, if investors favour particular corporate governance arrangements, we should anticipate that the shareholders of old firms will actively campaign for management to unify share classes in order to obtain lower costs of capital. Firms that find that their cost of capital is too high compared to the assumed advantages of their share structure will decide to strengthen their capital structure. We should, however, not expect that a small subset of firms that have controlling shareholders with little need to return to the capital market, will react quickly by altering the composition of their capital structure.

11. Board Neutrality

In the main, the debate in corporate legal theory over takeovers falls into two broad schools of thought. The board defence approach holds that shareholders are unable, due to limited experience, collective action and coordination problems, to make informed choices in the takeover context. Even if shareholders would acquire the proper incentives to become informed about the transaction, proponents argue that shareholders may lack the knowledge to assess the complex information. These reasons appear to support claims that the board should be permitted to erect defences on the grounds that they are better placed to protect the interests of shareholders.

In contrast, the shareholder choice perspective holds that boards are self-interested in their response to takeover bids and consequently should not be permitted to create defences (Bebchuk, 2002). Not only does board discretion reduce welfare by limiting the disciplinary effect of takeovers, but it also reduces shareholder value by attracting

only friendly deals, allowing managers to extract a disproportionate share of rents produced by such transactions. While there is no doubt that shareholders are disadvantaged in ordinary day-to-day business decisions, proponents conclude that shareholders are best positioned to take the ultimate decision in a takeover bid. However, dissatisfaction with the shareholder choice approach has led recently to the emergence of a hybrid, shareholder choice view – based on efficiency reasoning – which holds that undistorted shareholder choice may be insufficient to remove most of the barriers to takeovers. Some scholars note that the shift to a shareholder choice regime is not necessarily welfare enhancing since managers can simply entrench themselves further by employing pre-bid defences embedded in a firm's contractual arrangements that permit managers to restrict the number of bids (Arlen and Talley, 2003).

Against this background, the issues on the debate on the proposed Directive relate to the extent to which board neutrality is required. It has been argued that the policy choice between board neutrality and board discretion depends on the relative efficiency of capital markets (Wachter, 2002). Efficient financial markets are able to shift assets to their most valued use by providing the correct price signals. Thus, any bid, hostile or not, above the market value of the target firm would indicate an efficiency gain (provided takeover regulation excludes value-decreasing bids, as discussed above). Board discretion, therefore, would not be necessary. Hence a justification for board discretion in the context of a takeover should be related to market inefficiencies. Thus, if there are sufficiently large externalities in the takeover context, board intervention can be justified. However, such a showing may be difficult to prove empirically. The main trade-off entails that bad managers entrench themselves by rejecting value-enhancing tender offers against good managers seeking to maximise shareholder value by rejecting value-reducing tender offers. While there is good analytical support on both sides of the trade-off, the empirical evidence regarding this essential trade-off is thin on the ground (Kahan and Rock, 2003). In the following section, we analyse the trade-off between a simple rule about board neutrality and a complex provision that allows board discretion under pre-specified conditions by calling upon the German Takeover Act.

11.1 Defences in Germany

In 2002, Germany adopted a new Takeover Code Act to replace the voluntary Takeover code. The Takeover Act (TOA) is consistent with the general 'duty of neutrality' that prohibits the management from taking any unilateral action to frustrate the hostile takeover offer.[38] However, it provides the management of the target company with an expanded latitude of available defence mechanisms that can be generally deployed only by the consent of the supervisory board rather than the shareholders only. The 'duty of neutrality' does not apply to acts that would also have been performed in the ordinary course of performance, such as looking out for a competing offer and acts approved by the supervisory board of the target company.[39]

The defence mechanisms can be classified as pre-bid and post-bid defence mechanisms depending on the timing of their application. Furthermore, they can be categorised into

[38] See §33 (1) of the TOA.

[39] See §§33 (1), 33 (2) of the TOA.

two groups: measures requiring approval of the general meeting of shareholders, and measures that do not require such approval. Defence mechanisms that require shareholders' approval are: i) issuance of new shares, if there is no authorised capital requirement,[40] ii) buy-back of shares (generally limited to 10%)[41] and iii) sale of major assets and other major transactions.

Defence measures that can be launched by the management of the target company without shareholders' approval are: i) issuance of new shares, if authorised capital has been previously created by the general meeting of shareholders, ii) sale of some assets and distribution of cash proceeds in the form of dividends (sale of 'major' assets must be authorised by the general meeting of shareholders), iii) launching a counter offer for the bidder, given the availability of adequate financial means, iv) soliciting alternative offers, v) acquisition of a company in competition with the bidder to create antitrust and regulatory problems and vi) extending loans to the members of the management and supervisory board or their relatives.

The Act effectively empowers the management and supervisory board of the target with considerable power and a wide array of options to shield against a hostile takeover bid. However, the management and supervisory board are also constrained in the use of defence mechanisms because any such measure must be approved by 75% of voting shares, which in fact is a considerable impediment to overcome. The management and supervisory board of the target company, moreover, must not breach their fiduciary duty to loyalty and care.

Since the legislation was enacted, there have been no hostile takeovers where these above-stated provisions have been implicated.[42] With the German legal academy, scholars have attempted to delineate the scope of management discretion with or without shareholder approval. The range of actions that the management may undertake on its own is quite limited (Hirte, 2002, p. 634). One constraint on management is that they prove that a particular action would also have been undertaken in the absence of the bid. The second constraint is the provision that those actions that fall in the domain of the shareholder meeting do indeed require shareholder approval (see below). Finally, the third constraint is that many actions require supervisory board agreement.

There is a limited variety of defensive actions that the management may undertake with the approval of the supervisory board.[43] In terms of unilateral management board action, the Act states that these actions should not fall in the domain of the shareholder meeting.[44] If this constraint is satisfied, management and the supervisory board are permitted to erect defensive acts that are specific to the particular takeover situation. There is also a second constraint: both the management and supervisory board are bound by a fiduciary duty against the company's interest. In this context, the interest of the company is defined as the 'interests of shareholders, employees and the interests of society as a whole.'[45] Not surprisingly, the exact nature of what lies in the interest of a

[40] See §186 of the Stock Corporation Act.

[41] See §71 of the Stock Corporation Act.

[42] In Germany the only hostile-turned-friendly takeover in 2002 was Kamps/Barilla.

[43] See Hirte (2002, p. 640) and Schneider (2002, p. 129). The supervisory board has no right of initiative.

[44] From Art. 33 (3), regulating the shareholder reserve authorisations (see below).

[45] Hirte (2002, p. 643, quoting the justification for the law given by the German government.

company is widely debated in the German academic literature. Unfortunately, this debate has not made it any clearer whether a defence of a takeover bid could lie within the interest of a company.[46]

A third possibility for board discretion arises if the board has obtained, prior to a bid (*Vorratsbeschlüsse*), permission by shareholders. Reserve authorisations must generically describe the actions that the board may take. A reserve authorisation, furthermore, must obtain a majority of 75% of voting shares, and is only valid for a period of up to 18 months. Should a board decide to act upon such an authorisation, it is required to obtain supervisory board permission. Importantly, there is no apparent agreement in the academic literature as to the scope of this provision. It is argued that this provision covers any defensive measure that falls in the domain of the shareholder meeting (Hirte, 2002, p. 648). Naturally, the last option for the board to intervene *ex post* is to seek shareholder approval. In this case, approval requires a simple majority without excluding the bidder from the vote (Hirte, 2002, p. 645).

Based on the foregoing, the board's room for action is the residual set of actions for which legislation or the corporate charter do not foresee shareholder decision-making or for which shareholders have given their authorisation. If given *ex ante*, an authorisation is valid for 18 months, as opposed to five years for authorisations in circumstances other than takeovers. In this context, while boards have some discretion, they are restrained from taking actions that shareholders are required to decide. Moreover, they are not permitted to override shareholder decisions. In this regard, the German conflict with the proposed Directive would lie only with respect to the residual set of actions available to the board, and not with respect to a permission of board veto in general.

However, there is some dispute whether this is the only permissible interpretation of the German law. It is argued that supervisory board approval can be used to override shareholder decisions. Moreover, it is suggested that certain actions fall into the domain of shareholder decision-making. These are actions that directly alter the shareholder structure which fall into the domain of the shareholder meeting by law. As is well known, German courts have extended shareholder decision-making powers.[47] For example, a capital increase falls within the domain of the shareholder meeting. An abstract authorisation (outside a takeover context) of the board to increase capital may be valid for five years, but scholars disagree as to whether the use of this authorisation is also permitted when the company has become a target, especially in conjunction with the exclusion of pre-emptive rights of the existing shareholders. Some argue that the use of a general authorisation is not applicable in the takeover context (Hirte, 2002, p. 648). In contrast, others argue that the management (and perhaps the supervisory board) would still be required to justify this measure with the interest of the company (Krause,

[46] Krause (2002, p. 1056), quotes literature that argues that a company has no legally relevant interest in the composition of its shareholder structure. This would, in effect, make any discussion on board discretion moot. Other literature argues against this.

[47] See Bayer (2002, p. 602 and p. 619). Direct measures are listed in Art. 119 AktG. The *Holzmüller* decision of the BGH confers powers to the shareholder meeting also in a case when the shareholder structure was indirectly altered. It is unclear whether the supervisory board agreement can override such case law. (It is also an interesting question whether the *bidding* management has to consult its shareholders as well. It has to consult the shareholders for agreement to a capital increase but probably not on the specific target or the particular terms of the bid it makes.).

2002, p. 1058; Schneider, 2002, p. 129). It is worth noting that shares cannot be sold below value (Bayer, 2002, p. 611).

Similar arguments can be made for share repurchase agreements (Krause, 2002, p. 1059). The acquisition of shares of other companies may be seen as extraordinary business decisions by the management. It has been argued that these cannot be undertaken if they can be postponed until after the takeover process (Hirte, 2002, p. 644). But it may be possible that a supervisory board agreement will suffice to allow management to adopt such strategies. It is thus debatable whether cross-holdings and defensive holdings require shareholder approval or only supervisory board agreement. Furthermore, it is questionable whether this only concerns the case when new share issues are used to finance this investment or when free cash-flow is used. 'Crown jewel' defences, extreme 'golden parachutes' and 'pac-man' defences are not permitted by law (Bayer, 2002; and Schneider, 2002). Moreover, members of the management and supervisory board of the target company are liable to the company for any damage it incurs as a result of the creation of special rights conditional on the success of the offer.[48]

It is worth pointing out that the literature cast doubt on whether reserve authorisations to defend takeovers would be used much in practice. That is, it is assumed that the management would, by resorting to a reserve authorisation, reveal itself as a potential target and consequently trigger a fall in share price. Thus, it is argued that supervisory board agreement may be an easier mechanism for management to thwart bids (Krause, 2002; and Seibt and Heiser, 2002). As argued above, the legal uncertainty surrounding this provision may constitute a significant barrier to its use. However, we should expect that at least some management teams, having become an obvious takeover target, will choose to adopt share repurchases. Fostering takeover speculation in this way may raise the share price. Hence, the net effect in the stock price between decreased takeover probability due to shareholders' conferring of defensive powers to management and takeover speculation is unclear. Even though most assume that reserve authorisations will not be used in practice, it is noteworthy that some firms have argued that the provision is valuable.[49]

11.2 Conclusions on board neutrality

In this section we reported on the German takeover defences. Our survey shows why it might be preferable to have a single, simple rule such as board neutrality. In order to facilitate cross-border transactions, a simple European rule might be preferable. It is worth noting that the German example also illustrates that the lack of clarity on the allocation of decision powers in a company transcends the debate on takeovers into general company law matters. If we assume that a simple European rule is preferable for reasons of transparency, the question is what is the proper scope of this rule. In the present context, we suggest that such a rule would extend to takeovers, but not to the allocation of decision-making power in the general course of the company's business. We would, moreover, argue that a rule that is more favourable to outsiders should be

[48] See §93 of the Stock Corporation Act and §2.1 (2) of the CGC.

[49] Max Dietrich Kley, CEO of BASF and chairman of the German Association of Publicly Listed Companies, quoted in the *Frankfurter Allgemeine Zeitung*, 23 October 2002.

adopted since it is more likely to change over time. In this context, we prefer board neutrality as the regulatory choice since it works against incumbent management.

12. Squeeze-out

As noted in Section 1, the Commission embraced the HLG's recommendation when it introduced the squeeze-out right in the proposed Directive. A squeeze-out-right refers to the right (under specified conditions) of a majority shareholder to compel minority shareholders to sell their shares to him at an appropriate price. Although the squeeze-out procedure in the proposed Directive is uncontroversial, it is of interest for two reasons. Firstly, it constitutes one factor in the calculation of the minority shareholders when they determine to accept the mandatory bid or not. Secondly, the squeeze-out procedure deprives the concerned shareholders of their ownership rights against compensation. Squeeze-out may also be relevant to the issue of compensation for the loss of multiple voting rights. Some note that squeeze-out rules can be extended to cover the case of multiple voting rights and related control benefits.

The commonly supplied justification for providing a squeeze-out option is that retaining a small minority of shareholders can be costly (general assemblies would have to be arranged, shareholders notified, etc). As a practical matter, since control is no longer contestable, small shareholders have little hope of ever capturing the premiums from a control contest. Thus, the exclusion of the few remaining minority shareholders is efficient. As such, the squeeze-out procedure, which embeds the equitable price presumption into the squeeze-out mechanism, should by definition make the judicial review of the squeeze-out compensation superfluous. However, shareholders may resort to an independent expert or judicial review to determine the price explicitly.

12.1 The proposed Directive

Under Art. 14 of the proposed Directive, a majority shareholder can exert a squeeze-out under the constraint that he holds between 90% and 95% of the capital following a full bid (Art. 14 1(a)). Alternatively,[50] the squeeze-out can be effected following a bid on the outstanding capital with the constraint that it must have been accepted by shareholders representing more than 90% of the outstanding capital (Art. 14 1(b)). Share classes are accounted for separately (Art. 14 2). The equitable price in both cases can be determined in two ways. First, by a legal presumption on the 'fairness,' namely when the constraint is met that the bid attained 90% acceptances in terms of the share capital at which the bid was directed. In case of a prior mandatory bid, this threshold would not apply for the determination of an equitable price (Art. 14 3). The time limit during which the equitable price presumption remains valid is set at three months. Second, in all other cases, the squeeze-out price is to be determined by an independent expert (and in case of conflict, an appraisal proceeding) (Art. 14 4).[51]

This can create considerable confusion as to when the appropriate compensation mechanism applies. Suppose, for example, a bidder had no stake in the target before

[50] It is not so clear whether member states are supposed to have the choice between these alternatives or a bidder.

[51] In the light of the arguments below, one may wonder how an appraisal procedure could be conducted for each class separately.

launching the bid. At least 90% of the capital is needed to initiate a squeeze-out, which would correspond to at least 90% acceptances. However, if the bidder held an initial stake small enough that a mandatory bid became necessary, less than 90% acceptances would be needed to satisfy the 90% capital threshold and to ensure that the equitable price presumption applied. However, when the capital constraint is not satisfied – following a mandatory bid – the new controlling shareholder would need to launch a second bid in order to initiate a squeeze-out. Given that he has already a stake in the company, the 90% capital condition can be reached with less than 90% acceptances (as well as a 95% capital rule if the initial holding was at least 50%). But the equitable price assumption does not automatically apply. Rather, the price can be determined by an independent valuation as stricter conditions on the fair price presumption now apply. Still, if the second bid were to have received a few more percentage points of acceptances, the fair price presumption could have been applied instead.

It is understandable that the outcome is a compromise between different member-state traditions. However, it is submitted that a simple European rule would be preferable if the cost of harmonisation is not too costly. The question whether an expert valuation or the fair price presumption is applicable perhaps matters only at the margin. Appraisal proceedings are time-consuming and sometimes arbitrary. The Directive appears to have retained the appraisal proceeding as a possibility by virtue of choosing not to fully harmonise the squeeze-out thresholds. However, there are costs involved for agreeing on a threshold that is not sufficiently high, as the threshold itself is somewhat arbitrary. An acceptance threshold only matters if there is an upward-sloping supply of minority shares. To be sure, this is empirically difficult to ascertain, especially as the elasticity of supply may depend on minority shareholders' expectation about the outcome of an independent valuation.

For an evaluation of the squeeze-out provisions, two considerations are important. In what follows, we will first discuss the fairness claim (the focus of the Directive) and consider the two methods of fairness determination. Second, we will discuss whether the proposed rules are efficient. From an efficiency perspective, the squeeze-out procedure must be seen within the entire context of a takeover.

12.2 Fairness

As defined in Art. 14, an equitable price presumption relies on the shareholders to evaluate their shares with the offered compensation. This is often referred to as a 'market mechanism.' A rule similar to the one proposed by the Directive is set forth in the UK Companies Act. Transaction cost is the main justification for embedding the equitable price presumption in the squeeze-out mechanism. Accordingly, the savings in transaction cost stem from avoiding the cost of negotiations with individual shareholders. To illustrate this insight, we consider three alternative situations of price determination where we assume that a shareholder may wish to initiate a full merger. In case (a), the bidder engages in individual negotiations; in case (b), the bidder needs 100% acceptances for his proposal; and lastly, in case (c), the bidder needs less than 100% acceptances to initiate the squeeze-out (which corresponds to the proposed Directive).

Suppose first that the majority shareholder would be forced to negotiate with each minority shareholder individually over the compensation. Causal empiricism supports

the view that the transaction cost would be quite high. As a practical matter, the controlling and each minority shareholder would bargain over the gain in firm value, which would arise if the shareholder gave up his minority position, all else being equal. Since the minority shareholder would not be forced to give up his position at some point in time, he can always keep his shares as long as there is disagreement. In individual negotiations, his personal expectation of the future value of his shareholding would thus be the lower bound to his portion of the bargaining outcome. The distribution between the parties of the gain above this bound would depend on relative bargaining powers, for example the more patient party in the bargaining could be expected to attain a larger part. However, the majority shareholder may divert value from the controlled company as long as there is disagreement and thus weaken the minority shareholder's disagreement position. As a result, individual negotiations are, due to the large numbers of individual negotiations, very time-consuming and costly.

If the majority shareholder could make a public offer to the outstanding shareholders conditional on a 100% acceptance rate, this would give every minority shareholder a veto right on the whole process. The controlling shareholder would thus just have to hold a vote. This procedure decreases transaction costs dramatically. The minority shareholder with the highest valuation would *de facto* decide on the outcome for all shareholders. Finally, we must assume that the shareholder is required to obtain an acceptance rate of less than 100%. The equitable price presumption in the Directive thus constrains the veto power of minority shareholders, which makes the procedure fast and transaction cost-saving.

Which procedure protects minority shareholders most effectively? To begin with, in circumstances in which all shareholders are homogeneous in their valuation of the company, the acceptance threshold would be irrelevant. As a consequence, the supply of minority shares would be flat (either all tender or none at a given price). Against this background, it is often argued that shareholders have different expectations of the future returns on their shares. However, in perfect capital markets, prices should reflect value. In case of companies with a large controlling shareholder, the low liquidity of the market for the outstanding shares may justify the assumption of an upward-sloping share supply curve. It follows that the more diversified shareholders become, the less important becomes such a threshold.

This does not imply necessarily that minority shareholders would be better off with individual bargaining than under the equitable price presumption. Broadly, one can expect that the total squeeze-out compensation determined in individual negotiations would reflect the average valuation across the minority shareholders of their minority shareholdings (their disagreement payoff). Under a 100% acceptance rule to a public offer, one would expect that the total cost to the offeror reflected the highest valuation by a minority shareholder of his minority shareholding. An acceptance threshold of less than 100% lowers the compensation, but not necessarily below the average of a series of individual negotiations.

It is thus clear that the equitable price presumption carries some arbitrariness with it. This does not necessarily allow the possibility of judicial remedy against it. Courts can only reconsider facts, not presumptions. The arbitrariness is in the thresholds that lead to the presumption. However, one may wish to resort to a different fair price

determination procedure. It is argued that the alternative of an independent expert valuation does not fare any better in terms of arbitrariness, but instead adds costs.

12.3 Independent expert valuation

For every situation where Art. 14 does not presume an 'equitable price', an independent expert valuation, based on accounting methods designed to determine the 'intrinsic value' of the firm, is coercive. Because the Directive does not explicitly specify the procedure, we take the appraisal procedures applied in Germany and US as examples to show the main problems that can arise. Broadly, in order to initiate a squeeze-out, the controlling shareholder should propose compensation based on independent expertise. If a minority shareholder considers this as inappropriate, the judicial remedy available is the appraisal proceeding, which re-evaluates the company's value by more independent expertise.

Germany

The German approach to expert valuation of a company is analysed in an extensive study by Hecker (2000).[52] She focuses on parent-subsidiary contracts that must specify compensation for minority shareholders. The expert valuation in that case is similar to that used in squeeze-outs. When a shareholder (representing another company) has gained majority control, he could convene a general shareholder meeting to approve a contract between the parent and the subsidiary regulating the term of control. This contract must include a provision to compensate minority shareholders if they want to exit and a rent to be paid to them if they did not want to exit. The controlling shareholder would base the proposed compensation on a study by an external accountant. In case minority shareholders did not agree to the proposed compensation, the issue would be settled in an appraisal proceeding with additional accounting expertise.

During the time period of Hecker's study (the 1980s and the 1990s), the accounting practice was to consider the subsidiary as a going concern at the time when the shareholder meeting decided over the control contract with the parent company. 'Going concern' meant to take the business strategy of the company as given, which would reflect all business decisions by the controlling shareholder so far. Synergies between the companies that may arise from the contract taking effect were not to be included.[53] Information asymmetries between controlling shareholders and minority shareholders (for example, due to a lack of disclosure duties on hidden assets) are also taken as given. Hecker (2000, pp. 85-106) argues that such an approach would understate the intrinsic value of the company if the company had been independent under a sole owner.

The method commonly used in Germany is the valuation of profits method (*Ertragswertmethode*). This method is based on free cash flows, i.e. a forecast of returns on the assets of the company while maintaining its present substance. This can be set against the liquidation value of the company, which additionally takes non-substantive

[52] Her analysis concentrates on control contracts between parent and subsidiary. Other possibilities to exclude minority shareholders are mergers and going-private transactions. German law did not provide for explicit squeeze-out procedures prior to the Takeover Act of 2002.

[53] The German Takeover Act of 2002 confirms this practice. The compensation should reflect the business as a going concern at the time when the general assembly decides on the squeeze-out.

business assets into account. In this method, the discount factor for future returns is not based on an asset pricing model of corporate finance but is derived from the subjective judgement by the accountant. Only recently, German accounting practice has begun to accept the discounted cash flow method (DCF), where the discount rate is derived from models built from capital market theory, which give a market valuation of the risk premium.

Hecker found the application of the accounting methods to be arbitrary to a large degree.[54] Sine the estimation of the reinvestment rates necessary to maintain the substance would allow significant subjective judgement of the accountants, it would be difficult to separate substantive from non-substantive business assets. Even when the business strategy is taken as given, the cash flow forecasts can differ in how uncertainty is taken into account. Finally, there is the problem of finding the appropriate discount rate. In the valuation of profits method, the risk-free rate of return is augmented by the accountant's subjective evaluation of the risk premium (the compensation of the risk-averse investor for giving money to an uncertain project). The room for judgement is evidenced by the large differences between the initial expert studies and those commissioned in a subsequent judicial review, as shown by Hecker.

United States

The US applies an appraisal proceeding as a default rule to accomplish squeeze-outs. However, as the US does not have a mandatory bid rule,[55] the US debate on squeeze-out regulation must be seen from a different perspective. Coates (1999) explains that Delaware law on the means of company valuation in conflict transactions is non-binding. Companies would be free to adopt 'fair price' charter provisions, either to the benefit or to the disadvantage of minority shareholders in future squeeze-out procedures. However, companies would make little use of that freedom despite the considerable variation in court decisions on appraisals.

Delaware law[56] stipulates that in an appraisal proceeding the fair value should be exclusive of any element of value arising from the accomplishment or expectation of the merger. The debate on US law thus attempts to establish criteria based on fairness grounds. Booth (2001, p. 128) notes, however, that fair value can mean different things: 'In some cases, one may want to estimate the price at which one could buy or sell a controlling interest in a company. In other cases, one may want to estimate fair market value, that is, the value at which shares would trade in a completely undistorted market. Finally, in still other cases, one may seek to estimate the price at which a minority investor could actually sell shares.' Coates (1999, p. 1278) tries to ascertain the conditions under which a 'minority discount' would become unfair. In general, he argues that minority discounts constitute the difference between the value of control shares and the value of a minority share. "Accordingly, 'minority discounts' and 'control premiums' are simply the inverse of one another." Excluding synergies would be difficult, because it would require estimating the synergy value, the pure control

[54] Her case study contained a sample of 16 compensation expertises.

[55] Of course, it is incorrect to speak of 'the US'. Indeed, only two US states have approved the mandatory bid rule. Moreover, Delaware, which is the focus of this section, has not followed the mandatory bid approach.

[56] Delaware General Corporation Law, 262(h).

value and the expropriation value, 'none of which, in isolation, is easy to observe directly.'

Both Coates and Booth reviewed the Delaware case law, concluding that fair price proceedings are arbitrary. Booth (2001) explicitly considered the question whether the courts took account of control premiums that might have been paid in prior transactions. It is submitted that the company should be evaluated as a whole in order to treat shares of the same class equally.[57] Recent case law[58] states that 'premiums may arise from 1) the potential for looting; 2) the right to direct business policies; or 3) synergistic gains' (Booth, 2001, p. 140). Since planned changes in the business strategy for the target are not to be considered in an appraisal, the courts would face the difficulty to disentangle from this an 'inherent value of control' that would be paid even in the absence of the transaction in question. In the case referred to by Booth, the court argued that it was impossible to extract the factors that contribute to control premiums from the data. There the court took the data average of premiums paid in comparable company control transactions and reduced ten percentage points off the 40% average premium (as a proxy for the synergistic gains). This was added to the 'fair market value of the shares.' Booth (2001, p. 141) argues that this approach seemed to assume 'that most sources of premiums are part of the going concern value of the corporation that belongs to all stockholders.'

Analysis of the US evidence indicates that minorities participate to some extent in the takeover gains. It must be noted, however, that the US does not have a mandatory bid rule (and does allow for partial bids), so that in the initial takeover private benefits of control are usually not distributed to all shareholders. Plainly the American law on squeeze-outs established a lower bound to the dilution of minority positions to overcome the free-riding problem. DeAngelo, DeAngelo and Rice (1984)[59] argue that minorities *de facto* have a veto right in squeeze-outs because the success of a judicial review of the compensation depended on whether the decision on the squeeze-out by the general assembly had been supported by a majority of the minority shareholders. Wenger, Kaserer and Hecker (2001) argue, moreover, that for this reason the conditions for going-private transactions in the US often contain a clause that makes the validity of a squeeze-out decision by the general assembly conditional on a majority approval by minority shareholders.

The company's market valuation is sometimes taken as the lower bound to the compensation offered by the controlling shareholder.[60] The market value of shares reflects the market's expectation of the present discounted value of the minority holding in the controlled company, thus potentially excluding private benefits of the controlling

[57] According to the Delaware Supreme Court (Booth, 2001, p. 127).

[58] Agranoff vs Miller, No. 16795, 2001 Del. Ch. LEXIS 71 (Del. Ch. May 15, 2001). Although this was not an appraisal proceeding, the issue was to determine whether there was expropriation of particular shareholders.

[59] As quoted by Wenger, Kaserer and Hecker (2001, p. 324).

[60] This is common in the US. In Germany case law has accepted the market value as a lower bound since 1999. The market value contains the market expectation of the outcome of the appraisal procedure.

shareholder.[61] As noted above, low liquidity due to the few shares outstanding may depress the price somewhat. The market price also reflects the anticipated outcome of a squeeze-out procedure. Under the proposed Directive, this would ensure with some probability that an appraisal procedure is initiated.[62]

To sum up, independent expert valuations and appraisal proceedings tend to be arbitrary in the application of valuation methods. They are designed to arrive at a valuation independent of the market. Nonetheless, the valuations tend to include some market valuation, be it by estimating market discount rates or by taking the stock price as a lower bound to the compensation. In addition, they are time-consuming; for example, in Germany appraisal proceedings can well last for ten years (Hecker, 2000). Thus, it would be preferable to apply an equitable price presumption as often as possible because it lowers transaction costs and decreases the uncertainty over the outcome.

12.4 Efficiency

The optimal level of protection

Hecker (2000, pp. 93-102) argues that from a welfare-maximising perspective minority shareholders should not be expropriated after the control acquisition. This would eliminate inefficient takeovers, and in addition the capacity of the stock market to finance IPOs would be enhanced. She defines the appropriate compensation to be the marginal valuation of the shares of the seller if he held the same price-relevant insider information as the buyer. The seller price should also take into account the business strategies that would have been implemented if there had not been a merger. The calculation of this seller price should thus compensate for the possibility that the buyer (the controlling shareholder) will have the opportunity to extract private benefits (through transfer pricing, compensations, loans, etc.). This would correspond to the company run by a sole owner. Hence the compensation to the minority should even include those (hypothetical) synergy gains that could have been realised with other companies. Hecker (2000, p. 101) acknowledges that it would be impossible to detect in practice all extraction of private benefits from the subsidiary to the parent and to reattribute them to the subsidiary (with their hypothetical marginal returns at the subsidiary).

In most cases, a squeeze-out is initiated as a consequence of a control change. Thus the squeeze-out should not be seen as independent from the actual takeover. As we discussed above, it is necessary, in order to overcome the free-riding problem in takeovers, that minority shareholders do not participate in all the gains the takeover generates. The two mechanisms designed to overcome the free-rider problems were 1) ex post expropriation of minorities (dilution) and 2) private benefits available to the new

[61] This is not true of stock market prices before the takeover. The increase in the share price when a takeover is imminent is the anticipation of the distribution of private benefits (or synergies) in case control changes.

[62] There may be an additional problem as to when the majority shareholder initiates the squeeze-out procedure. The majority shareholder has an incentive to initiate the squeeze-out procedure when he knows that the shares are undervalued. This is an application of the 'lemons problem' in the economics of asymmetric information (Bebchuk and Kahan, 2000). This would create additional incentives to accept the mandatory bid, see below. This is not relevant when the squeeze-out compensation is tied to the takeover bid.

controlling shareholder. We noted further that the degree of dilution is determined by the incentive effects of takeovers on the incumbent management of the target company (Grossman and Hart, 1988). A squeeze-out of minority shares at a lower price than the market price for shares may satisfy such a requirement. On the other hand, the free-riding problem can be overcome if shareholders assumed to be pivotal in the tender or if the bidder can extract private benefits from the target company. Thus the optimal squeeze-out compensation may depend on the specific circumstances of the takeover, in particular whether the target was widely held, whether there were blockholders, whether there have been competing bidders or whether there is a mandatory bid rule.

Squeeze-out and mandatory bid

Does the squeeze-out procedure entail that the mandatory bid is coercive? As noted, the proposed equitable price for the mandatory bid is the highest price paid in the six to twelve months prior to the bid. The mandatory bid includes some share of the private benefits of the new controlling shareholder. Moreover, minority shareholders would be expected to decline such an offer if they expected the share price of the merged company – excluding the private benefits – would be higher in the future. They might also decline the offer if they considered the bid price to be lower than the target company's expected share price – again without any private benefits – if the company remained independent. The latter circumstance can lead to a pressure-to-tender if the non-pivotal shareholder expects the takeover to succeed despite his negative opinion. However, since the equitable price contains a distribution of private benefits, this seems to be an unlikely prospect.

Given the distribution of some of the private benefits, it may be reasonably argued that minority shareholders are sufficiently protected by the mandatory bid rule, so that additional strict requirements on subsequent squeeze-outs are unnecessary. Some coercion from the squeeze-out procedure to accept the mandatory bid seems appropriate to speed up the takeover process.

12.5 The squeeze-out mechanism as a blueprint for voting right compensation?

It may be useful to discuss the squeeze-out mechanisms from another angle, namely from the distribution of bargaining power when it comes to compensating for the loss of property rights. The compensation rule based on acceptances replicates a bargaining situation. That is, the controlling shareholder makes an offer which minority shareholders can accept or reject, but with some probability that their decision will not influence the outcome. Since this increases the chances that the controlling shareholder's proposal is accepted, the effect will contribute to an increase in his bargaining power. In other words, the disagreement payoff of the minority shareholders is set below that of the shareholder with the highest valuation of his minority position. Nonetheless, the procedure allocates considerable power to reject the offer to minority shareholders.

When the squeeze-out mechanism leads to a fair price presumption, can such compensation mechanisms be applied to changes in the corporate charter? With a view to proposals for compensation mechanisms for the break-through rule, it should be noted here that the squeeze-out acceptance rule rests on allocating to the shareholders

concerned a strong power to reject the offer. Otherwise such a 'market mechanism' would not lead to any compensation.

The appraisal procedure makes a clear distinction between ownership rights and control rights. It takes as a benchmark the minority position in a firm, excluding many private benefits of control. Even the redistribution of resources of the controlled company to its parent seems permitted to some degree. Such business plans are taken as given by the accounting methods that are used in the appraisal. The accounting methods do not make counterfactual calculations of using the controlled company's resources alternatively, for example by not transferring resources to the controlling company but using them in the subsidiary instead. Furthermore, the efficiency gains that result from the squeeze-out usually are excluded from the 'intrinsic value' calculations. As the evidence discussed above indicates, there is considerable room for interpreting what the 'intrinsic value' actually is.

In order to use the appraisal procedure to determine a compensation for the loss of voting rights (and some of the benefits of control), one would have to determine the 'intrinsic value of control'. From a pure accounting perspective, and without recurrence to market prices (share prices), this would include a guess of how much the decision rights over the company's resources are worth, possibly developing alternative scenarios of how retained earnings should have been invested (or distributed to shareholders).

12.6 Conclusion

To sum up, the squeeze-out procedure is a legal mechanism to deprive shareholders of their ownership rights. Compensation is found either by allocating strong powers of rejection to the shareholders or by independent experts who take the use of funds in the controlled firm as given. There are strong caveats to use these methods to compensate for the break-through rule.

In principle, the proposed squeeze-out rules are acceptable. The proposed thresholds beyond which a squeeze-out can be initiated still reflect national legal history. Since these thresholds are to some extent arbitrary, they may just as well be harmonised for simplicity sake. Little is lost in terms of regulatory diversity because the squeeze-out regulation concerns a well defined event and does not have trade-offs with other areas of corporate governance. Furthermore, it may be of little cost to streamline the rules such that an independent expert valuation is eliminated from the fair price determination. It seems like a matter of chance whether the fair price presumption or the independent expert valuation applies. The latter is inferior. The fair price presumption might also be streamlined. Given that the change of control by a takeover triggers a mandatory bid with its own – strict – fair price rule, the new controller should be able to initiate a squeeze-out under no further condition but to apply the takeover bid price, perhaps with a longer time horizon than three months.

In principle, the squeeze-out rules proposed in the Directive are acceptable. The proposed thresholds for a squeeze-out were designed to reflect national legal history. Since these thresholds are to some extent arbitrary, they may just as well be harmonised for simplicity. Little is lost in terms of regulatory diversity because the squeeze-out regulation concerns a well defined event and does not have trade-offs with other areas of corporate governance.

Furthermore, it may be of little cost to streamline the rules such that an independent expert valuation will no longer be available for a fair price determination. Under the current proposal, it seems like a matter of chance for both the controlling and the minority shareholders whether the fair price presumption or the independent expert valuation has to be applied. The latter is inferior.

The fair price presumption itself could also be streamlined. Given that the change of control by a takeover triggers a mandatory bid that has its own – strict – fair price rule, the new controlling shareholder should be able to squeeze-out shareholders that have not tendered without any restrictions other than having to offer the takeover bid price, perhaps with a longer time horizon than three months.

The squeeze-out procedure is not a blueprint for compensation of groups of shareholders in other circumstances. First, it explicitly (in the appraisal proceeding) or implicitly (in the fair price presumption) allocates some bargaining power to the shareholders that are forced to tender their shares. The allocation of bargaining powers under circumstances other than a squeeze-out may be a different issue. Second, the independent expert valuation evaluates the company as a going concern. It does not evaluate the relative weights of different shareholder groups in the distribution (and determination) of the market value of the company. Attempts to do so on the basis of industry data are to some extent arbitrary.

13. The Level Playing Field Considered and Conclusions

The market for corporate control in Europe is underdeveloped and highly segmented. The takeover market needs to evolve in order to enhance productive and allocative efficiency and to ensure greater financial market integration. A harmonised approach to takeover regulation is now needed to promote minority shareholder protection and to handle systemically the barriers that limit the operation of the takeover market in several EU member states. There is a real need to reach agreement on a minimum common regulation that could reduce the price of takeovers and thus lead to the acceleration of takeovers. In addressing the regulation of takeovers at the European level, a more economic approach, based on economic efficiency, is required.

Yet, fairness considerations have tended to overshadow economic efficiency concerns in the debate on the proposed Directive. For example, the main contribution of the High Level Group was the claim that the EC takeover legislation should support the creation of a level playing field for takeovers. It becomes natural to ask whether the fairness claim is ultimately the basis upon which the European Union has to make its policy choices about the regulation of takeovers. In our view, the level playing field claim is at odds with the central idea that a harmonised takeover code should be evaluated with respect to whether it would achieve substantial welfare benefits and transparency.

As we have seen, the EU debate on takeover regulation begins with the unexamined assumption that firms competing in the same market should be governed by the same rules. A recently proposed amendment by the Members of the European Parliament that allows for member states to block bids from a third country illustrates this type of reasoning. With the presumption that US state law allows for the board of directors of US companies to employ a range of *ex post* defensive measures without shareholder approval, the European Parliament implicitly assumes that this type of measure will give US firms an unfair advantage in the international takeover market. To the extent

that differences in legal rules distort the competition between US and EU firms, the US laws give a systemic advantage to its producers which should be addressed by corrective actions (*viz*. a reciprocity requirement). At first glance, these arguments appear to lend support to legislation designed to limit this unfair advantage, but mandating that the proposed Directive does not operate in cases that involve a bidder outside the EU may be difficult to justify on efficiency grounds. Notice that the reciprocity claim is not based on a present competitive imbalance between US and EU corporations in the transatlantic market for corporate control. Rather, a careful evaluation shows that EU firms have greater market presence in the US corporate acquisition market than US firms have in the EU. It should be evident, as the empirical research suggests, that there is by no means a conclusive presumption in favour of reciprocity since there is little evidence that US state law rules are discriminatory in nature and do not serve European investors' interests. In addition, US stock markets are commonly seen as the world's most developed and efficient. There is little question that it would be wrongheaded to introduce regulatory protections against firms that are listed on such markets if the policy goal is to strive for more efficiency in Europe.

Moreover, it cannot be taken for granted that the differences in national regulatory policies should be regarded as the basis for a reciprocity process that favours domestic producers in the EU takeover market. To the extent that jurisdictions have divergent regulatory policies, the source of differences in laws may be due to a range of factors (e.g. preferences, endowments, technologies, etc.). As a preliminary point it should be noted that the substantive legal differences alone may not reflect significant economic differences in competitive advantage between the EU and US. Because there is little empirical evidence that differing national preferences and regulatory policies have any effect on international trade patterns, the argument for reciprocity could be a solution for a small class of EU domestic firms that are going to be more successful in the EU takeover market as a consequence of a decision to subject non-EU firms to a substantive constraint. Another point to bear in mind from this analysis is that the pursuit of a level playing field with the US may end up being detrimental to the policy aims of EU lawmakers, which is to encourage good bidders who bring large efficiency gains. Hence, it is submitted that policy-makers should not be distracted by arguments based on equal treatment, particularly when it is likely that the particular claim for reciprocity is not supported by clear empirical evidence. Furthermore, since it is clear that the claim for fairness in trade competition is not well supported on economic grounds, it is submitted that the likely cost of adopting a reciprocity measure will result in significant distortions in the cross-border takeover market.

Similar arguments apply to proposals made by some MEPs to allow the national securities regulator to frustrate takeover bids if the bidding company has some degree of market dominance in its home country. This would imply that the securities regulator would have to decide on market dominance. Inefficiencies arising from market dominance are a matter for merger control. To overload the takeover directive with issues of market dominance would create conflicts between the competition authorities and the securities regulator. Furthermore, if a company used (legal) monopoly profits to acquire foreign companies, the efficiency cost would accrue to its customers, not the shareholders of the target company, since they are free to reject the bid. Again, the level playing field argument proves to be systematically misleading.

As we have seen, the empirical research supports the view that good bidders originating from jurisdictions with good corporate governance regimes tend to have a lower cost of capital. Correspondingly, a firm may have inherent competitive advantages in the takeover market as a result of its ownership structure and the particular governance characteristics of the firm. The simple reason is that well governed bidders find it easier to raise capital to finance their acquisitions. Moreover, this result is consistent with our earlier claim that corporate governance has a direct impact on corporate performance. In sum, the foregoing analysis suggests that there are gains to be achieved by creating an active cross-border takeover market that protects minority shareholders and promotes higher disclosure standards.

ANNEX A. STATISTICS

Table A.1. Sample composition: Type of bid and means of payment

	No. of M&As	No. of Divestitures
Total sample	158	29
Mergers	56	-
Friendly acquisitions	41	-
Hostile acquisitions	40	-
Multiple bidders	21	1
Bid on divestiture	0	28
UK target	59	11
UK bidder	53	13
Bidder and target same country	103	15
All-cash bid	93	26
All-equity bid	37	0
Cash/equity bid	18	0
% cash in cash + equity bids	45.9%	-
Cash/loan notes bid	3	2
Equity/loan notes bid	3	1
Cash/equity/loan notes bid	2	0
Choice cash or equity bid	12	0
Equity bid with subsequent cash offer	4	0
Ultimately failed bid	39	0
Ultimately successful bid	119	29

Note: This table details the composition of the sample: it distinguishes between different types of bids and means of payment.

Sources: *Mergers and Acquisitions Report*, *Financial Times*, and own calculations.

Table A.2. Country distribution of bids

	Domestic bids						Cross-border bids					
									Target country classification			
	Number of bids	Merger	Acquisition	Hostile bid	Listed target	Listed bidder	Number of bids	Listed target	Merger	Acquisition	Hostile bid	Listed bidder
All countries	118	40	31	44	85	86	69	51	16	22	13	56
UK/Ireland	74	24	16	34	56	52	19	14	4	4	6	14
Germ/Aust/Switz	7	5	2	0	6	4	18	12	3	8	1	12
France	16	5	6	5	11	13	7	3	1	1	1	13
Scandinavia	3	2	1	0	1	3	13	11	3	5	3	5
Benelux	6	2	4	0	4	4	8	7	3	3	1	8
Southern Europe	10	2	3	5	7	8	4	4	2	1	1	4
Central Europe	2	2	0	0	0	2	0	0	0	0	0	0
Total number of bids	187											

Note: The total number of takeover announcements is given by country. For the total number of bids by country, the number of listed target and bidder firms is shown.

Sources: *Mergers and Acquisitions Report*, *Financial Times* and own calculations.

APPENDIX B. DATA SOURCES AND METHODOLOGY

Information on share prices and market indices, on the risk-free rate by country (3-month Treasury Bill rates), on risk measures and accounting information was collected from Datastream.[63] Additional information on both targets and bidders was obtained from Datastream and the Financial Times: this information includes the industry codes (SIC), i.e. our measure of the degree of corporate diversification, financial data, the value of the bid and the means of payment for the bid. Panel A of Table B.1 shows that the market capitalisations of the target and bidder are not that different. This is a consequence of our sample selection criterion of a minimum bid value of $100 million. However, target firms seem to have somewhat higher growth opportunities as suggested by the slightly higher market-to-book ratio for the targets of 4.3 compared to 4.0 for the bidders. Furthermore, both the target's corporate performance (return on equity) and interest coverage are better than those of bidding firms. Panel B shows that the average bid value is $1.67 billion with a distribution that is strongly skewed to the right. In addition, panel B shows that the larger bids consist of a higher proportion of equity.

We measure the short-term wealth effects for bidding and target firms by calculating the cumulative average abnormal returns (CAARs) in an event study. The announcement data of the merger was taken from the *Mergers & Acquisitions Report* and verified to be the first public announcement that a bid was made or was going to be made. The event window starts six months before the announcement date to capture the effects of rumours or insider trading. There is little consensus about the start of the period for the measurement of the short-term wealth effects, as evidenced by the great variety of starting dates in published work. On the one hand, the measurement error may be substantial when using narrow event windows, especially if there was a leakage of information before the first mention in the financial press. On the other hand, there is evidence that bids follow positive movements in the acquirer's stock price. Hence, there may be a danger that by starting the measurement period too early, the actual M&A returns will be overstated.

To calculate the expected returns and verify the robustness of the returns, we use six different measures of beta (see below). First, we estimate the beta by running the market model over a 9-month period (195 trading days) ending six months prior to the event date. Second, as the beta from the first method is calculated over a period well before the event date, we estimate the beta over the 9-month period ending one month before the event date. This second method may be better at taking into account recent changes in systematic risk, but in turn it may be influenced by the event itself. Third, we use the Datastream beta which is corrected for mean-reversion. Fourth, we also adjust betas for mean-reversion using the Merrill Lynch method based on Blume (1979) in the

[63] For many of the developed markets, the company accounts data are adjusted, rearranged and repositioned by Datastream to provide consistent treatment of each item. For published items, some repositioning is necessary to achieve an acceptable level of conformity between companies. Datastream reports that 'adjusted levels of profits are achieved using a standard adjustment procedure; movements that do not relate to the company's normal business activities have been removed (e.g. as reported pre-tax extraordinary items, untaxed reserves, etc.)'. The adjustments applied will differ from country to country. However, comparability between markets (and also within a market) is restricted by different accounting policies and valuation methods. Datastream does not adjust for valuation differences. We downloaded the data in adjusted form.

following way: $\beta_i^a = .34 + \beta_i * .67$ where β_i^a is the beta adjusted for mean-reversion and β_i is the beta estimated using the market model over a 9-month period ending six months prior to the event. Fifth, the betas from method 1 are corrected for reversion to the mean according to Vasicek's technique using Bayesian updating (Vasicek, 1973). The degree of adjustment towards the mean depends on the sampling error of beta: $\beta_i^v = [\sigma^2_{\beta i1}/(\sigma^2_{\beta*1}+\sigma^2_{\beta i1}] \cdot \beta^*_1 + [\sigma^2_{\beta*1}/(\sigma^2_{\beta*1}+\sigma^2_{\beta i1})] \cdot \beta_{i1}$, where β_i^v is the Vasicek-beta for security i, β^*_1 is the average beta across the sample of shares estimated over the 9-month period ending six months prior to the event date (period 1), β_{i1} is the beta from the market model over period 1, $\sigma^2_{\beta i1}$ is the variance of the estimate of beta for security i measured over period 1, and $\sigma^2_{\beta*1}$ is the variance of the average beta measured over period 1 (Elton and Gruber, 1995). Sixth, we calculate Dimson-betas to control for inaccurate beta estimation resulting from thin trading which biases beta downwards (Dimson, 1979; and Dimson and Marsh, 1983). These betas are the sum of 5 parameter estimates of the market model in which the current level of the daily market return, as well as its first three lags and one lead are included.[64] The model is estimated over the 9-month period ending six months prior to the event date.[65] For all six estimation methods, the betas are trimmed at the 5%-95% distribution range. As none of the main results of this study IS influenced by the choice of the beta estimation technique, we only report results based on the Dimson-betas corrected for thin trading.

The abnormal returns are calculated as the difference between the actual daily returns and the expected returns obtained from the CAPM. The cumulative average abnormal returns (CAAR) are then calculated over the event period. The standard significance tests we apply are the ones from Kothari and Warner (1997). The one-day test statistic is:

$$\frac{AR}{s(AR)} \text{ where } s(AR) = \sqrt{\frac{1}{199}\sum_{t=-240}^{t=-41}\left(ARt - \overline{AR}\right)^2}$$

The test statistic for CAAR is $\frac{CAAR}{s(AR)\sqrt{T}}$ where T is the number of time observations.

The total gain for each pair of target firm and acquiring firm is measured by:

$$CAAR^{Total} = \frac{CAAR^{Target} * MV^{Target} + CAAR^{Acquirer} * MV^{Acquirer}}{MV^{Target} + MV^{Acquirer}}$$

where MV denotes the market value of the target's or acquirer's equity before the beginning of the event window (Cybo-Ottone and Murgia, 2000).

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[64] There will be more thin trading problems for continental European firms. Still, whether or not thin trading is a problem should not be solved at the level of the stock exchange but at the level of the firm. It would not do to apply thin trading corrections to firms traded in Paris but not to those in London as there are some French firms that do not suffer from thin trading and some UK firms that do. Therefore, we apply the thin trading correction for all firms. For those firms where thin trading is not an issue, the contemporaneous return covariance with the market return will be the highest and the lagged and leading betas will not contribute (or less) to the systematic risk. For those firms where thin trading does matter, the lead and lagged betas determine systematic risk.

[65] The systematic risk of all six estimation techniques is calculated using the all-share index for each country. For example, the betas of UK targets and bidders are calculated using the FT-All Share Index.

Table B.1. Descriptive statistics

Panel A. Financial data

	Targets		**Bidders**		**Divesting firms**	
	Mean	St. dev.	Mean	St. dev.	Mean	St. dev.
Market capitalisation ($mil)	17878	15192	21568	28038	15033	29694
MV/BV	4.26	8.88	4.01	5.20	8.13	22.3
Ncash/MV	0.07	0.16	0.09	0.14	0.08	0.08
Dividend yield (%)	3.97	3.50	2.78	1.59	3.19	2.27
Interest coverage	50.80	32.59	13.41	13.66	5.51	5.99
Price/cash flow	11.53	36.36	10.51	7.71	9.41	7.81
ROE (%)	6.13	7.11	5.5	4.83	2.11	4.52

Panel B. Value of bid and means of payment (in $mil)

M&As (158 cases)	Mean	Median	St. dev.	Min	Max	Q25	Q75	Non-zero median
Value of bid	5469	575	15694	100	147280	218	2492	575
Cash bid	1489	147	3403	0	24600	0	581	443
Equity bid	14255	0	28196	0	147280	0	100	2580
Cash+equity bid	3084	0	5318	0	19895	0	0	655
Cash+loan notes bid	114	0	13	0	127	0	0	114
Equity+loan notes bid	29881	0	15363	0	42729	0	0	34052
Cash+equity+loan notes bid	15779	0	22106	0	31410	0	0	31410
Divestitures (29 cases)								
Value of bid	481	415	310	110	1239	$212.55	682.75	
Cash bid	504	317	318	110	1239	160.4	681.75	423
Cash+loan notes bid	217	292	106	142	292	142	292	142
Equity+loan notes bid	370	0	0	0	370	0	0	370

Note: Panel A shows data on corporate size, growth opportunities and performance for target, bidder and divesting firms. Panel B shows average bid value as well as the financial composition of the bid. The market-to-book-value (MV/BV) represents the growth potential of the target; the interest coverage captures the potential financial distress; the amount of liquid assets (NC) (cash and short-term loans, deposits and investments) is divided by total market value. We calculated relative target-to-bidder size using the market capitalisation at least six months prior to the announcement.

Sources: *Mergers and Acquisitions Report, Financial Times* and own calculations.

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