Company Takeovers: Transparency Long Overdue

Company takeovers are becoming an increasingly frequent phenomenon as the globalisation of markets progresses. While hostile takeovers[1] have been common in the USA and Great Britain for decades, they have been more of a rarity in continental Europe. Such spectacular cases as Vodafone/Mannesmann, one of the few major hostile takeover attempts to take place on German soil, have now stirred those with an interest in economic policy into action. Both eminent politicians and the trade unions immediately called for preventive measures that would make future hostile takeovers as difficult as possible. However, takeovers are often the easiest way for companies to rapidly expand their business activities, to improve efficiency through economies of scale, to eliminate the competition, or even to save on taxes. The German government has now indicated that it acknowledges the importance of takeovers as a market-economy mechanism, but it also sees a need for regulation to ensure that micro- and macroeconomic interests are equally balanced in future takeovers. The government plans to impose stricter obligations on both the takeover and the target companies to provide information to the interested parties, so as to achieve increased transparency regarding the aims of the takeover and the measures that will be taken. Minority shareholders are to receive fair compensation, and adequate consideration is to be given to the interests of employees.

Vodafone's takeover of Mannesmann and the reactions in the German- and English-speaking press were a practical lesson in the differences in stock market and takeover culture between German- and English-speaking countries. Hostile takeovers, especially, regularly cause disquiet in Germany. After the announcement of Vodafone's hostile bid, eminent German politicians, such as the premier of North Rhine-Westphalia and the Minister of Finance, immediately called for new legislation that would at least make such mergers more difficult in future, if they cannot actually be prevented. The British reaction, by contrast, was one of surprise at the so-called 'shareholder value culture', of the German 'consensus society'. But opinions are divided in Germany too: whereas the trade unions are generally in favour of legislation that will make takeovers difficult, because restructuring[2] often involves job losses, industry is opposed to any form of regulation.[3]

Nonetheless, new regulations on takeovers are required in Germany because even more international takeovers can be expected in the future and because over half the German companies listed on the stock exchange have not yet accepted the existing voluntary code of behaviour. Thus, enterprises are not guaranteed competitive equality in the important areas of acquisition and reorganisation of company shares.

Against this background, the German government presented a discussion draft for a German takeover law on 20 June 2000.[4] Business associations, trade unions and other interest groups and experts expressed their views on the proposals at the end of July, and the cabinet will deal with the bill after the summer break. The takeover law is intended as the German contribution to the creation of a European financial market with standardised regulations on supervision. Other European countries, such as Austria, Switzerland and France, have already taken this step.

Hostile takeovers as an element of external company control

In the eyes of economists, hostile takeovers are an essential element of the market-economy system.[5] They force managers to seek maximum returns, and any manager who does not perform in accordance with the rules of the

[1] Takeover describes the process whereby the majority of the voting capital of a company is bought through (secret) acquisition of shares or through public offers to the shareholders. A takeover is considered 'hostile' when the management of the company being bought out (the 'target') resists the attempted takeover.

[2] Even when such 'reallocation of resources' ultimately leads to the creation of better enterprise structures and to improved efficiency – in accordance with the maxim that in a market economy each asset eventually ends up with the best owner – there are always winners and losers. Outsourcing and personnel reductions are negative side-effects from the point of view of those affected. In the Mannesmann case, it was no secret that Vodafone was only interested in the mobile phone section of the company. All the other areas (tubing, mechanical engineering, elevators, etc.) were to be sold off and used indirectly to finance the takeover coup.

[3] This was the tenor of the *Handelsblatt* business monitor March survey. Although 93% of the managers questioned believed that more German companies will be taken over by foreign firms, Germany's managers are not afraid of international takeovers. The large majority (82%) is actually opposed to restrictive legislation. Cf. H. Hauschild: 'Manager lehnen Gesetz gegen Übernahmen ab'. In: *Handelsblatt,* 18.3.2000.

[4] http://www.bundesfinanzministerium.de/uebernahmegesetz/start.htm.

[5] 'Hostile takeovers are probably the most effective way for shareholders to get rid of non-value-maximizing managers'. (A. Shleifer and R.W. Vishny: 'Value Maximization and the Acquisition Process'. In: *Journal of Economic Perspectives*. Vol. 2, Number 1, Winter 1988, p. 8).

Overview

Differences between Market-based and Relationship-based Financing Systems

Characteristic	Market-based system	Relationship-based system
Equity market capitalisation	high	low
Share ownership	yield-oriented short-term widely dispersed	value-oriented long-term concentrated
Block shareholders	rare	common
Changes in shareholders	common	rare
Role of banks	insignificant as controllers of company	significant possibilities for control (creditors, owners, seats on supervisory board)
	short-term financing of company	long-term financing of company
Control of management by shareholders	limited	extensive
Company goal	high yields for shareholders	secure market position

Source: DIW, adapted from J. Weigand: Unternehmenssteuerung, Rentabilität und Kapitalstruktur; Nürnberg 1999.

stock market risks being replaced following a takeover. Thus, even the possibility of a takeover has a disciplinary effect, and through this mechanism managers are not only controlled from within the company, but also by the market.

However, managers have numerous possibilities for resisting hostile takeovers. These include so-called poison pills in the form of increased share capital, which can take effect without the agreement of the shareholders – and with the bidder given no purchasing rights – in the event of a hostile takeover bid or when a single investor exceeds a certain share of the outstanding equity. Other 'defence mechanisms' employed are the issuing of registered shares (with restricted transferability)[6] and the sale of shares or other assets that might interest a potential 'raider'. While such measures reduce the attractiveness of the company's securities for a potential investor and raise the inhibition threshold for a company planning a buy-out, they still cannot entirely prevent a takeover from running its course.[7]

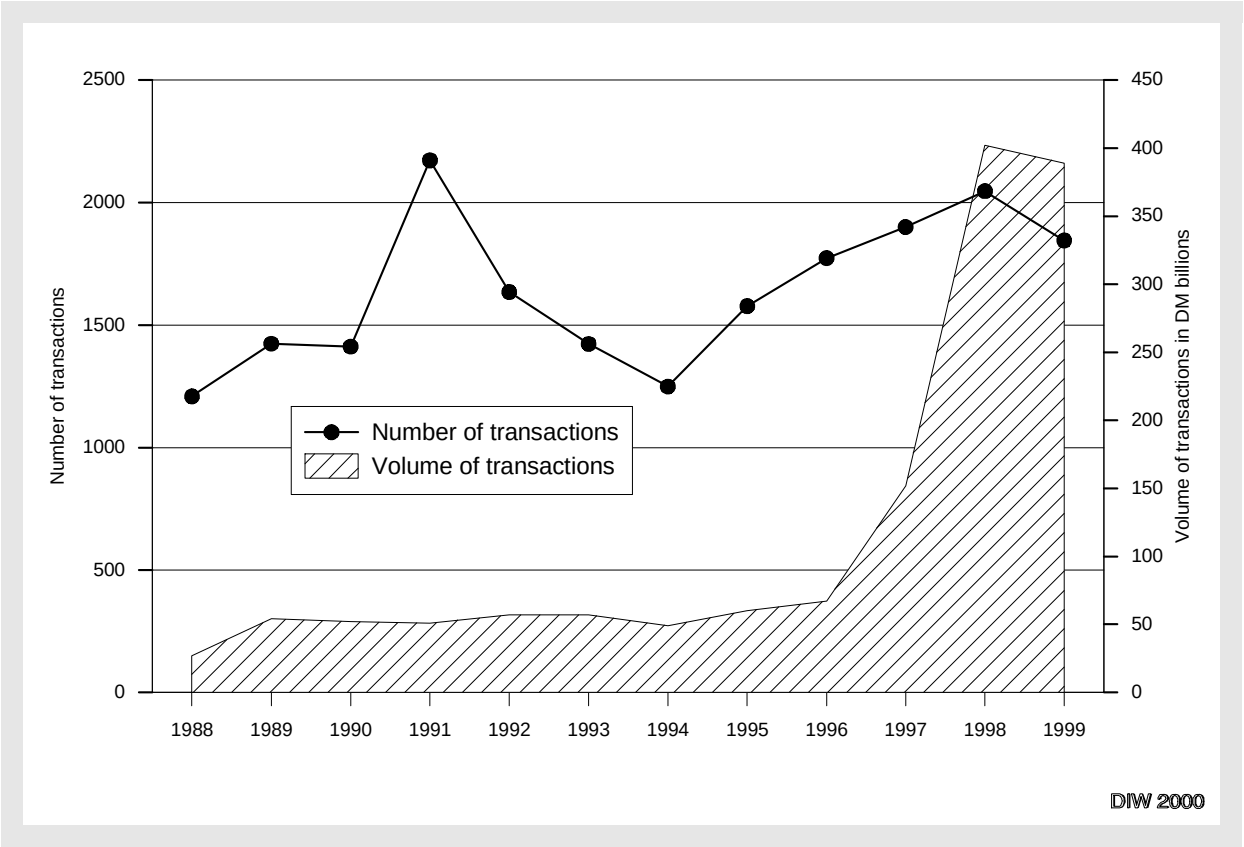
Many big German joint-stock companies have in addition shielded themselves against the immediate pressure of the equity market by means of a system of interlocking directorates (giving rise to the idea of Germany as one big company, 'Deutschland AG'). The managers and supervisory boards of such alliances of companies form a kind of network of reciprocal participation, and can thus achieve a majority in all the interlocked companies. Similar structures exist, though, in other countries of continental Europe and in Japan. Two basic types of enterprise culture can be distinguished: market-based systems and relationship- or consensus-based systems (see Overview).

[6] In contrast to the more common bearer shares, in the case of registered shares the supervisory board knows the names of the shareholders. This enables the board of the target company to analyse the shareholder group. Tying the shares means that individual shares cannot be transferred without the approval of the company.

[7] Also cf. M.W. Ebert and P. Kreibohm: 'Einen wasserdichten Schutzwall gibt es nicht'. In: *Handelsblatt*, 15.2.2000.

Figure 1

Number and Volume of Mergers and Acquisitions in Germany, 1988 to 1999



Source: M&A International GmbH, Königstein.

Motives for company takeovers

Companies buy out other companies for a variety of reasons (cf. figures 1 and 2 on German mergers),[8] and the differences between friendly and hostile takeovers are often only a matter of degree. The following are the general aims of takeovers (mergers): improved efficiency, economies of scale and scope,[9] cost benefits (communications advantages and reduced transaction costs) at different levels of the company – as in the case of vertical integration[10] – and diversification effects. In principle, such effects can also be achieved through internal growth, but takeovers are often the preferred option because the effects set in more rapidly and know-how becomes available sooner. Takeovers are often the fastest and simplest way for companies to extend their business activities to new areas and/or countries.[11] They can also be motivated by financial synergies and fiscal benefits.[12] Occasionally, the elimination of undesirable competition or protection against hostile takeovers can also

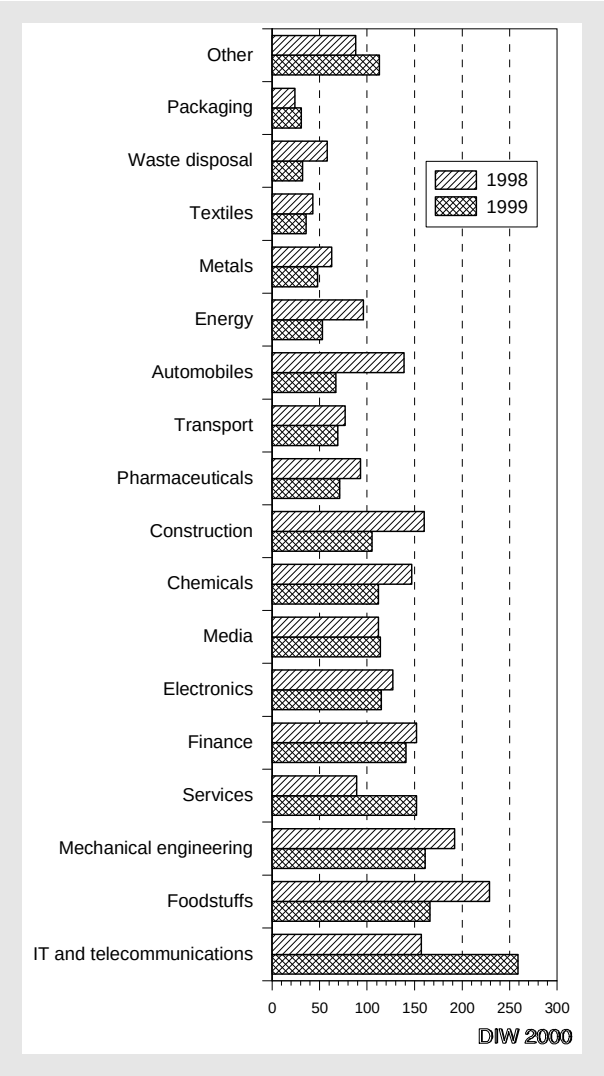
[8] 'Like the rest of us, corporate managers have many personal goals and ambitions, only one of which is to get rich. The way they try to run their companies reflects these personal goals. Shareholders, in contrast, deprived of the pleasures of running the company, only care about getting rich from the stock they own. Hence, when managers ignore profits to keep up traditional lines of business, conflicts are bound to arise. While many academic papers teach us that shareholder and market pressure will still force managers to maximize value, the newspapers remind us that this is not always the case. Much corporate behavior seems best understood in terms of managers running the show largely as they please'. (A. Shleifer and R.W. Vishny: 'Value Maximization and the Acquisition Process'. In: *Journal of Economic Perspectives*, Vol. 2, No. 1, Winter 1988, p. 7).

[9] The pharmaceutical industry is a typical example. A merger often results in a more efficient, critical company size. Globalisation enables, but also demands, the costly development of products for a marketing organisation operating on a global scale. Bundling of research and development reduces development costs and ultimately leads to better products for the consumer. Nowadays successful marketing also depends on an efficient global distribution network, but the enormous costs involved only pay off if the company has enough interesting, patented medical products to sell.

[10] Cf. K.J. Arrow: 'Vertical Integration and Communication'. In: *Bell Journal of Economics*, 6 (1975), Spring, pp. 173-183.

Figure 2

Number of Transactions in Germany by Sector, 1998 and 1999



Source: M&A International GmbH, Königstein.

play a part. Takeovers often prove to be a bad move from a purely business management perspective. Overestimation of the company's strength and over-optimistic market forecasts are the most common errors.

[11] 'Mergers are the fastest way to grow and diversify, and one expects growth-oriented managers to resort to them, unless their opportunities for internal expansion are exceptional.' (D.C. Mueller: 'Antimerger Policy in the United States: History and Lessons'. In: *Empirica,* 23 (1996), p. 236). Enterprise acquisitions are particularly facilitated by a low Tobin Q, measured as the ratio of the market value of a company to the replacement value of its assets.

[12] J. F. Nielsen and R. W. Melicher: 'A Financial Analysis of Acquisition and Merger Premiums'. In: *Journal of Financial and Quantitative Analysis*, 8 (1973), March, pp. 139-162.

Failure of self-regulation in Germany

The reactions to the Vodafone/Mannesmann takeover battle made it clear that takeover legislation is long overdue in Germany. There is a lack of clear-cut and binding legislation on the entire takeover process. The resulting uncertainty is probably also the main reason why the planned takeover initially drew such strong condemnation. While the so-called 'Guidelines for Company Takeovers', drawn up by the Ministry of Finance's Expert Commission on the Stock Exchange (BSK), have existed since the end of the 1970s, these have been largely ignored in practice.[13] The guidelines were replaced on 1 October 1995 by a code of behaviour drawn up by the BSK. It was intended to function as an instrument of voluntary self-regulation, which would guarantee the fair, transparent and smooth conclusion of public takeover bids. The cardinal principles were flexibility and practicality.

The intention was that the code would be accepted by potential bidders, target companies and financial service providers. However, only less than half of the German companies listed on the stock market have submitted declarations of acceptance to date. At last count, around two-thirds of the DAX 100 companies and almost 90% of the DAX 30 companies had approved the code.

The takeover code has not entered common usage on the capital market, unlike the 'City Code on Takeovers and Mergers' in Great Britain, for example, where takeovers, both friendly and hostile, are a day-to-day occurrence. The British Takeover Panel, founded in 1968 on the recommendation of the central bank and the stock exchange, ensures that takeovers are carried out in accordance with the code. The Takeover Panel is a 'semi-public' body, in that the supervisors are the interested parties themselves – bankers, industrialists and stock-market speculators – but they are carrying out a public task. London's takeover code is universally accepted, and banks that disregard it risk losing their securities licence.

The London model is characterised, in particular, by its functionality and speed. Although hundreds of decisions are made annually, few are ever contested, and the courts are rarely involved. These are the advantages of the body's semi-public character.[14]

Agreement was reached on a common takeover directive at European level in June 1999 – after some ten years of negotiations; the British takeover regulations served as a model. Under the directive, which is not yet

[13] Also cf. T. Pötzsch and A. Möller: 'Das künftige Übernahmerecht'. In: *Zeitschrift für Wirtschafts- und Bankrecht,* No. 31, 5th August 2000.

binding, the member states are to set the threshold above which a settlement offer must be made for all outstanding shares; the threshold may not, however, exceed one-third of the shares of the target company. As it stands, the directive's principle of equal treatment would prohibit discrimination between small shareholders and owners of blocks of shares who have been bought out. The EU model would oblige the company carrying out the takeover to offer to buy all the securities of all the shareholders, though there would be some room for manoeuvre with respect to the mode of payment.

In contrast to the situation in English-speaking countries and the planned EU provisions, small shareholders in Germany have had little protection to date against fleecing by potential buyers. This is due in part to the legal framework, but also to case law, which often had difficulty in recognising the legitimate interests of shareholders. Thus, cases have been reported where small shareholders were not offered a fair price for their shares following a takeover and were only able to achieve concessions after tedious legal battles.[15]

The German government's bill

Once the EU directive on takeovers comes into force, the member states will have to transpose it into national law. Against this background, on 9 March 2000 the German chancellor convened the first session of the new Takeover Commission, made up of representatives of the government, large enterprises and the trade unions.[16] The commission agreed on ten cornerstones for a German takeover law,[17] and these were recommended to the government and parliament as the basis for the subsequent legislative procedure. The government then presented a discussion draft based on the cornerstones. Under the terms of the bill, not only would the interests of small investors be strengthened, but information about the objectives of a takeover would be improved, which would also imply adequate consideration being given to the interests of the employees. The explicit inclusion of the employees in the takeover process from the outset is a significant new departure compared with past practice in Germany, and goes much further, for example, than the provisions in the British regulation.

One important aspect of the takeover law is the fact that all the shareholders of the target company would be treated equally, provided they own the same type of shares. The shareholders would have enough time to assess the takeover bid and would receive sufficient information about the bidder. It is assumed that the supervisory board and the management board will always act in the interests of the target company. The law lays down tight deadlines in the interests of a speedy procedure, so that the restrictions on the business activities of the target company can be kept to the absolute minimum, in order to avoid potential competitive disadvantages.

Voluntary and compulsory offers

The takeover law includes stipulations regarding both voluntary offers, aimed at acquiring a controlling share of an enterprise, and compulsory acquisition, to protect minority shareholders once control of the target company has been achieved.[18] The obligation to make an offer to all the shareholders would apply – except in exceptional cases – whenever at least 30% of the voting shares in a company are bought. This would enable minority shareholders to sell their shares at a fair price to the bidder, even in the case of takeovers not preceded by a public bid.

[14] The takeover code would probably be less effective if the parties involved were able to sue and take takeover quarrels before the courts. But the Takeover Panel has considerable powers of implementation because outsiders attempting to operate on the stock and financial markets come up against both legal and practical obstacles. If necessary, the Panel can call on the established institutes in the financial sector to refuse to do business with the party that has violated the regulations.

[15] For example, after taking over Boge AG, Mannesmann AG's offer to small shareholders was compulsory exchange of two Boge shares for one Mannesmann share. This amounted at the time to around DM 145 per Boge share. However, DM 416 per share was being paid over the counter for blocks of shares, and the market price at the time was fluctuating between DM 340 and DM 440. Cf. E. Wenger and R. Hecker: 'Übernahme und Abfindungsregeln am deutschen Aktienmarkt'. *Ifo-Studien – Zeitschrift für empirische Wirtschaftsforschung,* 41 (1995), pp. 51-87. Also cf. E. Wenger and C. Kaserer: 'German Banks and Corporate Governance: A Critical View'. In: Hopt, K.J., H. Kanda, M. J. Roe, E. Wymersch and S. Prigge (eds): Comparative Corporate Governance – The State of the Art and Emerging Research, Oxford 1998, pp. 499-535.

[16] Representatives from the funds sector were not invited. This is surprising, given their significance on the stock market: over a quarter of the untied 'simple capital' (*Einfachkapital*) belongs to fund clients. In addition, the funds sector has long been considered the leading example for constructive practices in the takeover business.

[17] Press release, 20.5.2000. Internet: http://www.bundesregierung.de/dokumente/artikel/ix_9446.htm.

[18] There had been resistance in Germany for years against the obligation to make a public takeover offer which would then be proposed to the remaining shareholders.

Price regulations for compulsory acquisition

One of the most controversial aspects of the planned takeover law is the procedure for laying down the offer price, in other words the price that a majority shareholder must offer the individual shareholders in the event of a compulsory offer. There was a debate on the question as to whether premiums paid over the counter for blocks of shares[19] should be taken into account when the price is fixed. The discussion draft currently provides for a combination solution. Firstly, the price offered by the bidder must at least be equal to the average market price for the previous six months; secondly, the price may not be more than 15% below the highest price paid by the bidder during the preceding six months. The average-price regulation levels out severe price fluctuations, while the 15% regulation enables minority shareholders to participate in premiums on blocks of shares.

Exchange of shares versus cash payment

The bidder should be free, on principle, to offer shares in exchange for shares bought in the target company. A general obligation to pay cash would probably mean that large-scale takeovers – so-called mega-mergers – would be virtually impossible, because they could no longer be financed. If cash offers were to be financed through loans, the risk of the bought-out enterprise being broken up would increase.[20] Nowadays, mega-mergers are usually financed with shares or a mixture of cash settlement and a share-exchange proposal.

The current bill basically leaves it up to the bidder whether to compensate the shareholders of the target company in cash or shares. However, the bidder is obliged to make a cash offer – as in the British takeover code – if he has bought over 5% of the shares for cash during the last six months. The same applies if he has bought one or more shares for cash during the bidding phase.

Regulations on information

One of the fundamental principles of the takeover law is the fact that all the parties involved – shareholders and employees – must have access to all the necessary information about the takeover. It has often been shown in the past that the success of mergers may be jeopardised if the consequences for the enterprises and operations belonging to the target company and for its employees are not laid out clearly in the takeover plan (e.g. Deutsche Bank/Dresdner Bank).

Under the terms of the regulation proposed in the discussion draft, when takeovers are carried out in Germany, the bidder must fully inform the shareholders, the board of management and the employees of the target company in a written document about the takeover and its effects. The shareholders and board of management must be informed about the future business activities (changes in the product range, closures and relocations). The transparency requirement also applies to the target company, which generally has all the necessary information for assessment of a takeover bid at its disposal. The board of management must immediately inform the employees and state its position. Thus, all the parties involved can gain an informed impression of the takeover bid. In addition, the bidder is obliged to provide the employees with information, in particular about his intentions with respect to possible relocation of the company headquarters, plans to relocate or spin off important parts of the enterprise, his intentions regarding the employees, changes in the operating conditions and the effects of the intended measures on employee representation. The obligation to provide information has more than only declaratory value, because in this way the employees are truly involved in the takeover process from the outset.[21]

Obligations on the target company

Only after the bidder has satisfied these extremely comprehensive obligations concerning information does the obligation on the management of the target company to desist from any act which could thwart the offer take effect. The important exceptions to this regulation – as in the EU directive – are: looking for another attractive offer (a knight in shining armour), implementing defence mechanisms agreed at the general assembly during the bidding phase, and increasing share capital while maintaining the purchasing rights of the shareholders, provided the relevant general assembly decision was not made over 18 months before the deadline for acceptance. The board of management and supervisory board of the target company are, therefore, not entirely defenceless during the takeover process.[22]

[19] What is the limit for a block of shares? 1% or 10%, DM 10 million or DM 10 billion?

[20] In order to pay the purchase price, the enterprise carrying out the takeover would be under greater pressure to 'gut' the company it has bought and turn part of it into hard cash.

[21] M. Berger: 'Das deutsche Übernahmegesetz nimmt Formen an'. In: *Die Bank,* 8/2000, p. 563.

Short deadlines

The short deadlines provided for in the bill – the bidder must submit a detailed offer within two weeks of announcing the takeover – impose difficult requirements on the enterprise seeking to buy out the target company. In order for them to provide the information required in the bid, they need considerable knowledge about the company they wish to take over, which can only be compiled at considerable effort by specialised personnel in so-called mergers and acquisitions departments. Thus, takeovers require extremely thorough preparation and can no longer be carried out in a surprise coup. While the concepts submitted are largely legally binding, in the event of deviations there is probably little scope to pursue such matters through the courts.

Conclusion

One characteristic of globalisation is the increasing importance of the international financial markets for the growth of national economies and enterprises, and takeovers – both friendly and hostile – should be seen in this context. They are an element of well-functioning market economies and have an important role in ensuring the efficient allocation of resources. National economies that want to participate successfully in the competition for attractive capital investments must open up to the international capital market and as far as possible create conditions that promise attractive returns. As far as the creation of economic conditions is concerned, policy-makers must weigh up whether they can pursue the same national objectives as before or whether they need to adapt to circumstances. After initial hesitation, the German government has now made it clear that it is willing to make Germany more attractive as a financial location by abolishing the tax on sale of shares and creating transparent conditions for enterprise takeovers.

The draft takeover law is basically in line with the EU directive and aims to create a stable framework for takeovers, which are an essential element of an efficient capital market. Improved information and transparency are intended to increase the confidence of the investors and to raise the level of acceptance for takeovers. At the same time, the interests of enterprises, managers, (small) shareholders and employees are to be given consideration in a balanced way. This is no easy task, given the different enterprise cultures and practices that exist throughout the world. It is certainly to be welcomed that all the parties involved, including the employees, are to be informed fully at an early stage of the proceedings about the aims, individual measures and consequences. This means that badly prepared takeovers will be prevented, and both the target company and the employees will be given room for manoeuvre. It is well known that in the knowledge society human beings are the most valuable capital, and a successful merger requires as much acceptance as possible by the workforce.

What is needed is not more protection against takeovers, but a regulated procedure that takes into account the internationalisation of the economy and guarantees that not only micro- but also macroeconomic interests are duly considered. It is unfortunate that it did not prove possible to achieve self-regulation of enterprise takeovers in Germany and that legislation was thus required. Whether the law will live up to expectations remains to be seen, and whether it gives sufficient consideration to market dynamics will depend not least on the implementation regulations. If it does not, the takeover law could quickly turn into a 'takeover prevention law', because the requirements are too strict. Policy-makers should thus ensure that instead of intricate legal regulations, the law leaves enough scope for decrees to be issued, permitting flexible solutions.

Alfred Haid and Kurt Hornschild

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[22] Fears on the part of the trade unions that German enterprises could be 'swallowed up' more easily by American enterprises than vice versa should therefore be put to rest. Cf. H. Putzhammer and R. Köstler: 'Eckpunkte für ein Übernahmegesetz'. *Mitbestimmung,* 5 (2000), pp. 22-23.