Takeovers and mergers: some major issues

Mr David Walker, an Executive Director of the Bank, comments[1] on some current issues of shareholder/company relations.

He starts by contrasting the Takeover Code, with its explicit recognition of shareholder interests, with US statutory provisions; and notes some possible implications of increased reliance on statute. He goes on to review the issues raised by the question of pre-emption rights, arguing for the need for flexibility to accommodate different approaches, subject to agreed guidelines and clear procedures for consultation with shareholders. Finally, he discusses the role of takeovers and mergers and, while fully recognising the constructive contribution that takeover activity can make to corporate efficiency, stresses the need for more effective board/shareholder accountability if the often excessively sharp correction represented by a takeover battle is to be avoided.

The advantage of being the opening speaker is the flexibility that this provides about the ground to be covered. I propose to touch briefly on three closely connected areas, some of which will no doubt be covered more fully in presentations coming later in the conference. If there is a single theme on which I want to place emphasis throughout my remarks, it is on the priority of the position of the shareholder in our system. I believe that such a priority is wholly correct, but it does carry significant implications that may not always be adequately appreciated.

The Takeover Code

I address, first, the Takeover Code, on which I want in particular to compare its provisions with the quite different American approach. A major objective of the Takeover Code is to ensure equal treatment of shareholders. The first 'general principle' of the Code specifies that:

> 'All shareholders of the same class of an offeree company must be treated similarly by an offeror.'

It is not a concern of the Code either to promote or to deter takeovers. In this respect, the policy objective in the United States is very similar, with a major objective of Federal regulation of takeovers accepted by the SEC to be:

> 'Take-over regulation should not favour either the acquirer or the target company, but should aim to achieve a reasonable balance while at the same time protecting the interests of shareholders and the integrity and efficiency of the markets.'

While there is a close parallel between this and the Takeover Panel principle quoted previously, it is important to note that the balance between offeror and offeree referred to in the SEC formulation implies a concern for the company as an entity in a bid situation at least equivalent to the concern to safeguard the interests of shareholders. This difference of emphasis is in practice extremely significant, with concern for shareholder interests playing a much larger role in the objectives of the Takeover Panel. Whereas a central plank of the Takeover Code is the requirement that an offer to all shareholders becomes mandatory when the 30% ownership threshold is reached—such mandatory offer to be at the highest price paid by the new controller in the previous 12 months—the SEC has no comparable requirement. Nor does the SEC impose constraints on the action of directors in bid situations comparable, for example, to the Panel's restrictions on 'frustrating actions' by the boards of offeree companies. The main SEC requirements relate to disclosure, and the principal SEC sanctions arise where there are material omissions from, or misleading statements in, disclosed information.

The absence in the SEC case of any obligation to make an offer when a specified threshold is reached means that substantial shareholders are often favoured through the possibility of partial bids and because there is no precise requirement that the same price be offered to all shareholders, for example when control is gained in two stages, described, I understand, as a 'front-end-loaded offer'. The arbitrageur is thus able to play a much larger role than in this country and this, it seems, tends generally to tilt the balance somewhat in favour of the offeror.

But the differences from UK practice are not all on one side. The SEC provisions not only allow a much freer hand generally to the offeror but also leave the management of the target company free to adopt defensive strategies such as sales of material assets and issue of new shares, most of which are proscribed under the Code unless they have specific shareholder approval. Poison pill techniques are proscribed in this country by both the Stock Exchange Listing Agreements and the

[1] In a speech at the University of Glasgow, on 21 May.

investor protection committees. The requirement under SEC provisions is that defensive tactics adopted by offeree managements should satisfy the business judgement rule which, in effect, means that the action taken by the board is in the interests of the business and the shareholders. I understand that, in practice, the use of poison pill techniques commonly involves litigation that culminates, in many cases, in a failure by the offeror or other plaintiff to prove that the tactics were not in the interests of the business and shareholders. The consequence is that bids in the United States involve much greater uncertainty than in this country and that prime responsibility for the determination of acceptable practice lies not in the hands of regulators but in the courts. As a recent SEC report states '. . . Litigation always accompanies contested takeovers and sometimes accompanies uncontested takeovers.' Such litigation in the United States appears to be facilitated, and some would say positively encouraged, by the legality of contingency fees (long banned in this country) and the existence of class actions; in contrast, litigation in takeover situations has hitherto been extremely rare in this country.

Federal regulation in the United States is most directly focused on management action in takeover situations. The shifting balance in contested bid situations between arbitrage on the offeror side and the defensive tactics of target managements makes the public policy objective of neutrality extremely difficult to achieve and, given the high cost of litigation and of the defensive action typically taken by managements, forces into sharp relief the question 'what constitutes a free market environment?'.

It is particularly interesting in this respect to note the recent US controversy, involving a ruling last month by the Supreme Court, on the takeover provisions introduced by the state of Indiana. These were apparently designed to give shareholders a larger say in bid situations by creating an obligation on offerors to seek, at certain threshold points, the assent of disinterested (or, as we would say, non-concert-party) shareholders before proceeding with share purchases. In very broad terms, this appears to be a move in the direction of the provisions of our Takeover Code. It was widely criticised in the United States as an anti-takeover statute even though, on 21 April, the Supreme Court ruled the Indiana statute to be constitutional. As I understand the American position, the matter of shareholder rights to vote has traditionally been one for the states in the United States, and I presume that this was a factor in the Supreme Court's decision.

Be that as it may, the Takeover Code in this country, directly concerning itself with the rights of shareholders rather than of managements, is much clearer in its constraints. There is sometimes a tendency to regard the Panel as typifying a cosy club approach, but this is a misreading of the position. The Panel has been and continues to be tough and, above all, capable of very swift decision. Public attention has focused on the very small minority of cases where there has been difficulty. But the Panel has in general worked very effectively in ensuring fair treatment for all shareholders, indifferently as to whether takeovers succeed or fail, and based on the principle that a properly conducted and managed takeover is a perfectly proper and healthy part of the business environment. The principal doubt has related to the lack of direct investigative and enforcement powers in an environment in which the powers of other regulators in this respect are being substantially boosted. Strengthening of the base of the Panel is provided or in prospect as indicated recently by the Secretary of State, and I believe that present arrangements, fortified by the measures just announced, will continue to work effectively. But much depends on whether practitioners and their clients want them to work. If, at some stage in the future, a situation developed in which many companies, in pursuit of their perceived interests, seemed intent on persisting in action which involved serious breach of the Code, it would plainly be necessary to consider further reinforcement.

I do not know what any such further reinforcement would comprise. What is clear, however, is that it would be very difficult to take statutory underpinning very much further without parallel creation of a right of appeal to the courts against Panel decisions. Whereas the Master of the Rolls has ruled that it is appropriate for the decisions of the Panel to be subject to judicial review, he opined that this would normally be an historical rather than a contemporaneous review. If statutory provision created—as it surely would—the possibility of appeal to the courts against Panel decisions, not just judicial review, then it seems unavoidable that awkward timing problems would arise. I do not know what assurance there could be that the courts would be able to handle such appeals without delay, but it is hard to see how appeal situations could be handled without a freezing of bids, at least in some cases. The possibility of achieving such a freeze could, of course, be very attractive to defending managements, but I wonder whether it would be seen in the same light by their shareholders and it would, in any event, seem certain to entail higher costs.

Pre-emption rights

I turn now to my second topic, the rights of shareholders generally which, in the British system, are very clearly recognised not only in the Takeover Code itself but, of course, in companies legislation much more widely. I want to make a number of observations on the subject of pre-emption rights, one that has recently come to the fore and on which some of the debate appears to involve as much heat as light. The case for pre-emption rights in general, that is, the rights of existing shareholders to have the first opportunity to subscribe to new issues of equity by their companies, seems to me to be wholly sound. I observe in parenthesis, however, that there is here also a sharp contrast with the United States, where the pre-emption right provisions that used to exist no longer survive. On the basis that there is general acceptance that pre-emption rights should in general be maintained (and despite the sharpness of some of the current debate, I am not aware of any serious suggestion that they should be abandoned in this country), the argument is thus about the circumstances in which, and the extent to which, shareholders should be ready to entertain waiving their rights through disapplication or other means.

This requires some review of potential costs and benefits. Where raising new equity from other sources involves the inducement of a discount that is more than marginal, this entails a cost for existing shareholders. In contrast, the issue of new shares at a discount to existing shareholders does not entail such cost because the company that is raising new capital in this way is wholly theirs. It is thus entirely proper that shareholders should be attentive to these cost considerations when propositions for disapplication of pre-emption rights are made.

Some of the alternative techniques now available for raising new capital—for example, placings or bought deals—can be put in place much more quickly than rights issues. But the principal argument in the direction of flexibility is that, with access to foreign sources of capital now greatly enhanced, the overall cost of capital to a company which is able to issue in foreign markets may be usefully lower to the company as an entity than if it is confined to rights issues to existing shareholders. As a result of the lower cost of capital to the operating entity, its ability to compete with other companies that are similarly able to tap other capital markets may be greater than if the company is restricted to rights issues. Moreover, once foreign demand is stimulated, the share price may tend to be higher than in the absence of such an initiative to broaden the shareholder base, and present shareholders will thus benefit. Such a broadening can, of course, be achieved through promoting foreign purchases of shares already in issue, but it would be argued, at any rate by market practitioners, that a foreign buyer is more likely to be attracted by a new issue of shares than by promotional effort in the secondary market. The market intermediary is not, of course, disinterested in this respect because he stands to earn much more from arranging an issue transaction than merely playing an agency role in the purchase and sale of shares already in issue. But the argument that new foreign investors are more likely to be attracted to a new issue plainly has some force.

How are these differing factors to be assessed? In a nutshell, the difficulty is that issue to another shareholder group at a discount involves an immediate cost to existing shareholders, even though it may involve immediate cost-saving to the company as an operating entity. Such net benefit to the company as an entity may feed through to the company in the form of its membership only in the slightly longer term. Seen in these terms, however, there may be little difference between widening the shareholding base after a disapplication of pre-emption rights and the ultimate advantage to shareholders that may be seen by managements in other actions such as investment in new plant and machinery or enhanced expenditure on R and D. The common feature of all of these is that they may disadvantage present shareholders by reducing what is available for distribution in the short term even though they may bring substantial benefit later.

It is sometimes argued that damage is done to existing shareholders by dilution when capital is raised other than by rights issues. But it is not clear what substantive damage is done by dilution when control is not at stake; after all, existing shareholders can always reconstitute their positions if they wish to do so by buying in the market, although not necessarily on terms as favourable as the issue price. The impact of dilution is certainly a good deal less real than the impact on shareholder interests of other actions by boards which are not subjected to anything like the shareholder scrutiny that is reserved for proposals for the disapplication of pre-emption rights.

All this underlines that flexibility will be needed to accommodate different approaches in different cases. While it seems essential that there be some agreed guidelines or limits, and clear procedures for consultation before specific resolutions are finalised and circulated to shareholders, there should also be flexibility to enable a company in which shareholders have confidence and which makes a good case, to make a somewhat larger non-rights issue than might be tolerable in other cases.

In this context, I should refer to sub-underwriting arrangements and commissions which confuse and, in some respects, distort the argument about pre-emption rights. Most rights issues are underwritten, and thus the maintenance of arrangements that involve sub-underwriting by the institutions on attractive terms fortifies their interest in pre-emption rights. In fact, the two matters are totally separate. It would be undesirable for sub-underwriting commissions to remain immune from the forces of competition which have swept away other monopolistic or cartel pricing arrangements in the City and elsewhere, including in particular the displacement of the fixed commissions formerly paid by institutions themselves on their Stock Exchange transactions. Underwriting commissions have already been squeezed in the context of privatisation and, to the extent that non-rights issues take place, these will introduce further competitive pressure. In addition, companies may become somewhat readier than in the past to undertake deep-discounted issues that are not underwritten, thereby maintaining the rights of existing shareholders but saving the cost of sub-underwriting commissions. This may not be invariably to the liking of market intermediaries who would themselves also lose commission in consequence, but a movement in the direction of non-underwritten issues by a number of major companies could introduce a healthy degree of competition.

Mergers and acquisitions

I turn to my third and last topic, the role of mergers and acquisitions in the context of the rights of shareholders and the accountability of boards to them.

There is immediately a sense that takeover activity is in something of an 'off' phase after what seemed the frenetic pace of activity in 1986 and the earlier part of this year. One welcome reason for the slowdown is the apparently greater interest of the corporate sector in new real investment as distinct from acquisitions, partly in turn a consequence of the very favourable margins and business conditions that are now being enjoyed. There is no doubt also a phase of digestion of what was absorbed in 1986—after all, even the most successful of conglomerates have some management constraints.

But while there is an understandable disposition to see the slackening in M and A activity as a relief, this needs to be seen in perspective. It is interesting to note that, expressed as a proportion of the end-year market capitalisation of listed companies, the value of takeovers even in 1986 was only 4.2%. The fact that this is a much lower figure than, I suspect, most people would have reckoned reflects the very widespread public debate that takeovers generate, in particular where they are contested. It is also consistent with the view that takeover activity has made a contribution to corporate efficiency not only through the mergers and acquisitions that have taken place but through the sharpening influence of the apprehension of others that did not. We are all too close to it in terms of time, but I think that the business historian in a later period will look back to the 1980s as a phase of enormous improvement in the efficiency of British industry generally—not just manufacturing—and will include in the explanatory factors two major external sources of pressure on companies. The first was the world recession of the early 1980s, when a process of cost-cutting and pruning back to essential and viable businesses was forced on many companies as a matter of life or death. While this left deep scars, it also brought large benefit, the fruits of which are now being reaped.

I suggest that the business historian would identify as the second source of pressure the phase of takeover activity that has characterised the mid-1980s and which has in many cases kept companies on their toes in a way that in some cases may have exceeded even the influence of competition in the world market place for their products. Why should this have been so? The question becomes more important the greater the degree of optimism that buoyant trading conditions are set to continue (that is, that the disagreeable stimulus of declining markets will be absent) and the greater the pause in takeover activity. The fact that the question can be posed in these terms is in itself an oddity, because there plainly must be methods by which shareholders can influence the boards of their companies short of the threat of assenting to a bid that the board might not itself want. Yet I think that our business historian, looking back on the recent and current period, will stress the significance of the influence brought to bear on companies through the threat if not the event of takeover, and that many boards had an awkward and ambivalent relationship with their shareholders in many other situations.

This subject of shareholder/board relationships is immensely important, but we should not suppose that the problem is either new or unique to our business life in this country. As far back as 1932, Berle and Means wrote in the United States about the diminished relevance in modern business of the concept of capitalist democracy, involving full and effective accountability of board to shareholder. And as we have already seen, boards in the United States are able to take initiatives, for example to strike back against attacks on their continued independence, in ways that may be far from clearly in the interests of their own shareholders. It is noteworthy here, for example, that poison pill techniques do not appear to require specific shareholder ratification in the United States.

Precisely because the formal interests of shareholders are much more explicitly recognised and protected in this country, but also because of the greater concentration of shareholder power in institutional hands, the task of developing more effective board/shareholder accountability would seem more tractable here than in the United States. It may help to restate the question in deliberately rhetorical terms. Does the effective operation of the free market necessarily require a lengthy period of decline, including share price decline and loss of confidence, in a company, followed by an often excessively sharp correction?

The sharp correction here is, of course, the takeover battle and its conclusion. The prescription that I would favour for mitigating or avoiding the need for such sharp correction is neither original nor unfamiliar, but it deserves a brief restatement. It comprises two main elements. The first is greater shareholder readiness to insist on board change when there is dissatisfaction with the quality and composition of a board or with the direction (or lack of it) that a board appears to be taking. The second and complementary requirement is for boards to be more effective in disclosure to and communication with their shareholders, in particular about how they plan to improve and develop the business, and maintaining such communication as normal good practice, not merely in a defensive situation where shareholder proxies are sought to counter an unwanted bid.

These propositions have become familiar, and I believe that observable progress is being made. This is very important because it is far from clear how sustainable progress can be made other than through education and persuasion. Corporate decline that is not arrested at an early or intermediate stage tends to be very wasteful of real resources, and the real adjustment that comes at the end of the day, after a phase of unchecked attrition, may be needlessly big and expensive. The real resource argument is becoming if anything still more significant as performance in the world market place grows in significance for more of British business, and the real loss sustained through opportunities missed is thus similarly magnified.

But however much improvement in corporate efficiency is secured through more effective relationships between shareholders and boards, as well as by other means, takeover activity seems set to continue as an important element in our business and market process, even though the pace may be slower than recently. I also think that argument that does not acknowledge the very constructive role that takeovers can play deserves to be treated with some scepticism. But there is clearly a danger, as with debate on many other public policy issues, of oversimplification. Within the market place itself, it is, for example, very important that shareholders should be well informed about the accounting conventions used by a bidder and be able to judge how far a particular bid is likely to bring enhanced efficiency through synergy, or for other reasons, and how far its attraction rests on the currently highly rated paper of the bidder. From the standpoint of public policy, the task, one in my view of protean difficulty, is how to determine the criteria to be applied as relevant without effectively second-guessing or threatening to override the market in each and every case. I have no doubt that these criteria will be the subject for much of the discussion in today's conference.