Is the Board Neutrality Rule Trivial? Amnesia About Corporate Law in European Takeover Regulation

Carsten Gerner-Beuerle, David Kershaw, Matteo Solinas

LSE Law, Society and Economy Working Papers 3/2011
London School of Economics and Political Science
Law Department

Is the Board Neutrality Rule Trivial? Amnesia About Corporate Law in European Takeover Regulation

Carsten Gerner-Beuerle, [*] David Kershaw, [**] Matteo Solinas [***]

Abstract: Whether the European Union's Takeover Directive should have adopted a mandatory neutrality rule has been the subject of much debate. As the European Commission commences its review of the Directive this debate is being reignited. A view is crystallising that the success and failure of the Directive can, in large part, be measured by the number of Member States that have opted-in, or out of the neutrality principle, or have opted-in subject to the reciprocity option. The contestability of European corporations is viewed through this lens as a function of the extent to which EU Member States have adopted an unqualified neutrality rule. This article takes issue with this viewpoint. It argues that the pre-Directive debate and the post-Directive assessment have failed to consider the core lesson of takeover defences in the United States, namely that the construction of defences and their potency are a function of basic corporate law rules. If corporate law rules do not enable the construction of takeover defences, or undermine the extent to which they can be potently deployed, then the adoption or rejection of the neutrality principle in Member States is of trivial significance. This article explores the triviality hypothesis in three central EU jurisdictions: the United Kingdom, Germany, and Italy. It concludes that, although there is variable scope to construct and deploy takeover defences in these jurisdictions, the triviality thesis is well founded.

---

[*] London School of Economics and Political Science.
[**] London School of Economics and Political Science.
[***] School of Law, University of Glasgow. We would like to thank Gemma Mootoo-Rajah, the participants of The Irish European Law Forum, '*The Takeovers Directive Five Years On – A Reflection of Takeover Regulation in Europe*' (University College Dublin, December 2009) for comments on the argument set forth in the paper, and to Blanaid Clarke for encouraging us to write the paper.

INTRODUCTION

In 2004, after a long and difficult legislative process, the European Union adopted the Takeover Directive.[1] The final product was widely viewed as a failure.[2] For many it represented yet another example of how politics and interest groups interfere with the introduction of the regulation necessary for creating a level playing field in corporate law in the European Union; another example of how domestic politics gets in the way of advancing the overall economic interests of the Union and its Member States.

The primary reason for this sense of failure was the inability to reach agreement amongst the Member States that the so-called 'board neutrality rule' should be a mandatory rule which had to be implemented by all Member States, rather than, as the Directive provides, an optional rule.[3] A neutrality rule provides restrictions on board activity once a bid has been commenced or is imminent. These restrictions prevent a unitary board of directors or a management board from using corporate powers provided to them to frustrate the bid without obtaining shareholder approval for using the powers for such a purpose. The term 'neutrality', whilst widely used, is somewhat misleading as the requirement is not that the board remains neutral. In all Member States the board is required to give its views – whether in favour or against – on the hostile bid,[4] and can legitimately search for an alternative and, in their view, more favourable suitor.[5] It is only in relation to the use of board power to defend a bid where such a rule neutralises or disempowers the board in the absence of contemporaneous shareholder approval.

In the United Kingdom a board neutrality rule, referred to in the UK as the non-frustration principle, has been in place since the late 1960s. Today the rule is set forth in Rule 21 of the Takeover Code and provides a general principled prohibition on frustrating board action together with a detailed set of specific rule-based prohibitions, including, for example, in relation to the issue of shares or options and the sale of assets and non-ordinary course transactions. The non-frustration rule was introduced in the UK in response to what was perceived to be the abusive use of board power to issue shares to fend off unwarranted bids in the 1950s and 60s. It was introduced at the same time that the UK's Takeover Panel

---

[1] Directive 2004/25/EC on takeover bids (OJ L142/12, 30.4.2004) ('Takeover Directive').

[2] See for example 'Watered-Down EU Takeover Directive is a Missed Opportunity for Open Markets' (20 December 2003) *Financial Times,* observing that 'Germany made common cause with the Nordic countries to make the new proposals' most meaningful provisions optional. That meant that company managements could still use poison pill defences without shareholder approval'. See also 'EU Reaches Takeover Code Compromise' (28 November 2003) *Financial Times* and M. Gatti, 'Optionality Arrangements and Reciprocity in the European Takeover Directive' (2005) 6 *European Business Organization Law Review* 553, 561 observing that that 'if we analyse the main reason why the [Takeover Directive] created so much dissatisfaction among the experts, we observe that its political failure is ascribed to the fact that the board neutrality rule is not binding'.

[3] Takeover Directive, n 1 above, arts 9, 12

[4] ibid, art 9(5).

[5] ibid, art 9(2).

was formed, not as a result of direct government action but through the actions of market participants in the City of London who, under the shadow of possible government intervention, imposed both regulation and a regulator upon themselves.[6]

Prior to the enactment of the Directive, a strong view developed in European policy and regulatory circles that the UK's non-frustration rule represented a best practice approach to European Union takeover regulation.[7] There were three primary drivers of this view. First, a harmonised board neutrality rule was necessary to generate a level playing field in the European single market that would enable the efficient organisation of European businesses: sand in the wheels of the market for corporate control necessarily gets in the way of efficient combinations. Secondly, this view reflected a strong shareholder sovereignty orientation that steadfastly viewed a contractual takeover offer as an investment decision for shareholders, not as a business decision which could justify board action. The third driver of this view was the prevalent distrust of management; a view driven by the dominant managerial agency cost framework of contemporary corporate law scholarship. From this viewpoint, although there may be shareholder friendly rationales for takeover defences, given the opportunity managers will use corporate power to resist a bid to protect themselves and their private benefits of control rather than to protect and benefit shareholders.[8] The context within which the non-frustration rule was introduced in the UK also contributed to this best practice viewpoint. The UK's non-frustration rule was formed outside of politics by the multiple constituencies of the City of London's financial community. A rule which is untainted by the compromises of the political process is readily perceived to be economically sensible. Although government may have nudged the UK financial market place to regulate itself, the actual solutions reflect the preferences of the market place, which ultimately is concerned with shareholder value.

Whether or not these drivers of the 'best practice' viewpoint are well founded is beyond the scope of this paper, although it is worth noting in passing that a degree of doubt has entered the UK debate and has recently been the subject of review both by the Takeover Panel and the UK Government.[9] This 'best practice' policy debate is a second order debate which flows from the assumption that

---

[6] For an excellent account of the historical background leading to the adoption of the Takeover Code, see J. Armour and D. Skeel, 'Who Writes the Rules for Hostile Takeovers and Why? The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727.

[7] 'The High Level Group of Company Law Experts on Issues Relating to Takeover Bids' (2002) (the Winter Report).

[8] The Winter Report observed in this regard that 'management are faced with a significant conflict of interest if a takeover bid is made […] their interest *is* in saving their jobs and reputation instead of maximizing the value of the company for the shareholders. Their claims to represent the interests of shareholders or other stakeholders are likely to be tainted by self-interest. Shareholders should be able to decide for themselves' (emphasis added) (ibid, 21).

[9] See Takeover Panel, *Review of Certain Aspects of the Regulation of Takeover Bids* (PCP2010/2) at <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PCP201002.pdf>; and the Panel's Response Statement at <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/2010-22.pdf>.

whether or not Member States have adopted the board neutrality rule makes a difference to whether or not boards of Member State companies can in fact use corporate power to resist bids. The debate and the political wrangling surrounding the status of the board neutrality rule in the Directive made a binary assumption that a Member State that has a mandatory neutrality rule prevents boards of its companies from using takeover defences without shareholder approval, and that a Member State that does not have a neutrality rule allows the boards of its companies to use corporate power to effectively resist unwanted bids, without having to ask shareholders for permission to do so. This binary assumption continues to drive the assessment of the Takeover Directive's effectiveness. The post-implementation debate views the extent to which corporations in the EU are open to takeover unhindered by board action as a direct function of whether the Member State which governs the activities of the corporation has adopted the neutrality principle, or adopted it subject to the reciprocity principle.[10] This assumption drives a view of the Directive's success that looks to the before and after of the Directive's implementation: how many Member States have a neutrality rule before and how many have it now; how many Member States had an unqualified neutrality principle before and now have a neutrality rule subject to the reciprocity requirement. Indeed, if this is the measure of the Directive's success, then important recent work shows that it has fallen short.[11]

The problem with this assessment of success of the Takeover Directive and the problem with the process that produced the Directive is that this binary assumption on which it rests may not be, and we do not know whether it is, correct. Although it is clearly correct that a jurisdiction, such as the UK or Austria,[12] that has adopted an unqualified board neutrality rule, prevents boards of its companies from using corporate power to frustrate a bid without obtaining contemporaneous shareholder approval, the flip-side of the assumption is more problematic. The debate on the use of board controlled takeover defences appears to assume that as takeover defences exist and are deployed in some jurisdictions, most importantly in the United States, that in all jurisdictions *but for* a board

---

[10] See European Commission Staff Working Document, *Report on the Implementation of the Directive on Takeover Bids* (2007) particularly its assessment of the impact of the adoption of the reciprocity principle allowing companies to dis-apply the neutrality rule where the bidder company is not subject to the rule. Those Member States that had a neutrality rule in the first instance and now have one subject to reciprocity 'have increased the managements' power to take frustrating measures without the approval of the shareholders […] this development will very likely hold back the emergence of an open takeover market, rather than promote it'. For financial media reports reinforcing this binary assumption see: 'Doubts Grow on Efficacy of Takeover Directive' (12 June 2006) *Financial Times,* reporting on an analysis by the European Group for Investor Protection on the implementation of the Directive; 'EU Takoever Law in Tatters' (27 February 2007) *Financial Times*; 'Expected Surge in Hostile Bids Turns Spotlight on Defences' (15 October 2009) *Financial Times*. See also P. Davies, E. Schuster, and E. van de Walle Ghelcke, 'The Takoever Directive as a Protectionist Tool' (ECGI - Law Working Paper no 141/2010) at <http://ssrn.com/abstract=1554616>). Note however that Davies, et al engage with and, in our view incorrectly, reject the triviality argument.

[11] See Davies, et al, ibid.

[12] Übernahmegesetz, s 12 (Austrian Takeover Law).

neutrality rule such defences would be available and, where available, that they *would be* effective for resisting a bid for non-legitimate reasons such as to entrench management. However, it does not follow that a Member State that has not adopted the neutrality rule enables and permits directors of its companies to create and deploy takeover defences without obtaining shareholder approval. Whether it does so depends on the corporate law of that jurisdiction. And it does not follow that where a jurisdiction's corporate law makes such defences formally available to boards that in practice they can be used by managers to protect themselves. Again, this depends on the corporate law of that jurisdiction.

It is in our view surprising that so much human and political capital has gone into the enactment of the Takeover Directive and the assessment of its success or failure without first obtaining a comprehensive assessment as to whether or not, in each of the Member States, the adoption or rejection of the board neutrality rule makes more than a trivial difference to the defensive capability of the board. This article intends to make a contribution to this assessment. It does so by asking whether the board neutrality principle is trivial in three key European jurisdictions: the UK, Germany and Italy. It does so by asking whether the corporate law in these jurisdictions renders board controlled takeover defences available at all, and if it does whether in these jurisdictions such defences are practically effective for resisting hostile bids. If takeover defences are either unavailable or practically ineffective in these three jurisdictions then it suggests that the European neutrality principle debate is far too much ado about nothing. If they are significant in some but not other jurisdictions then it suggests that a similar assessment of all Member States must be made before we can draw any conclusions about the effects of the Directive's implementation; and that such conclusions cannot be based on the acceptance or rejection of the neutrality rule alone.

1. EFFECTIVE BOARD CONTROLLED TAKEOVER DEFENCES

1.1 THE EUROPEAN EXPERIENCE

To assess whether corporate law in any jurisdiction would allow board controlled takeover defences to be constructed and used effectively one needs to understand what types of corporate action can have a defensive impact. For a jurisdiction such as the UK it is difficult to answer this question by looking only at the UK's experience of hostile takeovers. The reason for this is, of course, that boards of listed companies have been prevented from experimenting with the production of such defences by the Takeover Code's non-frustration rule which has been in place since the late 1960s. This meant that during the 1980s, the decade in which for the first time we saw a significant amount of hostile activity, boards and their advisors were not in a position to act creatively to fashion defences. However, although prior to this date hostile bids in the UK were a relatively rare event, there

are several pre-Takeover Code examples of boards deploying takeover defences. Most commonly boards attempted to prevent a bid by issuing a large block of shares to a friendly third party.[13] Other examples of defences included offering to buy-back shares,[14] and the sale and leaseback of key assets.[15]

In many other European jurisdictions although hostile takeovers have not, until recently, been subject to a non-frustration rule, other constraints have prevented boards and their advisors from creatively exploring how corporate power could be deployed to resist bids. Most importantly in this regard is the fact that in many of those jurisdictions small and large companies alike typically have a controlling shareholder who has either a large economic holding in the company or controls the company through control enhancing mechanisms such as pyramids or multiple voting shares. In such companies hostile takeovers are excluded by the fact that control is not available for purchase without the agreement of the controller. Clearly in the absence of hostile takeovers boards of companies in these jurisdictions have not had an opportunity to explore the availability and effectiveness of board controlled takeover defences. Of course, in most such jurisdictions there have always been companies that are widely-held, and anecdotal evidence suggests that the number of such companies is increasing. Nevertheless the pool of such companies remains small, and the number of hostile events they have generated has been inconsequential.[16]

1.2 THE US EXPERIENCE

To understand the full range of ways in which corporate action could be used defensively we need to look at a jurisdiction which has experienced a significant amount of hostile takeover activity and yet has not been constrained in the development of takeover defences by a board neutrality rule or shareholder ownership structure. Most importantly in this regard is the United States, which provides us with a, arguably complete, set of the imaginable ways in which corporate power can be used by boards to resist bids. As followers of the US takeover defence debate will be well aware, in the United States there are a myriad of examples of takeover defences. Some of them can be put in place by the board acting alone, others require shareholder approval to amend the constitution, and others are imposed by State takeover statutes on companies that do not opt-out by

---

[13] See, for example, T.I. Reynolds' bid for British Aluminium and the battle for Metal Industries Ltd: see Armour and Skeel, n 6 above, for an account of these events.

[14] See *Hogg* v *Cramphorn Ltd* [1967] Ch. 254, where the company funded a trust with a loan to enable the trust to offer to buy back shares at the share price the potential bidder had proposed.

[15] See the sale and lease back put in place by the Savoy Hotel Ltd in 1953. See L.C.B. Gower, 'Corporate Control: The Battle for the Berkeley' (1955) 68 *Harvard Law Review* 1176.

[16] This is of course not to say that although they are few in number, that they have had an inconsequential effect. Vodafone's hostile bid for the widely-held Mannesman AG was instrumental in the then German Government's opposition to a mandatory board neutrality rule.

amending the constitution.[17] Here we are concerned only with board controlled defences that can be put in place without shareholder approval and only with those which have functioned effectively to deter or frustrate bids. In our view those defences can be categorised in three ways (in decreasing order of potency): the creation of poison pills through the issue of warrants; the restructuring of the company's equity through share issues and buy-backs; and the sale of key assets in the company.[18] We take Delaware corporations and Delaware corporate law as our reference points.

1.2.1 The poison pill/shareholder rights plan

As is well known, a poison pill or a 'shareholder rights plan' involves the issuance of a share warrant or option for each outstanding share. The warrant attaches to the share and is transferred with it. Upon issue the warrant is significantly out of the money and would therefore never be exercised by the holder. However, if a triggering event occurs, the warrants are detached from the shares, and the terms of the option are dramatically altered to enable the holder to purchase shares in the company at a discount. Typically the discount is 50 per cent of the shares' current price, but this is of course a function of the contractual terms that apply to the warrant which are determined, in a Delaware corporation, by the board. The triggering event is typically the acquisition of a certain percentage of shares, for example 15 per cent or 20 per cent of the corporation's outstanding shares, without having obtained the target board's prior approval. The ability to exercise the warrants and purchase shares at a discount following a triggering event does not apply to the bidder who triggers the pill. As the bidder is excluded, the pill when triggered results in significant value dilution for the bidder. Today the most common and potent pill is a flip-in pill that provides options to purchase shares in the target; a flip-over pill enables shareholders to buy shares in the bidder company or its subsidiary on the merger of the target with the bidder or its subsidiary. Importantly, the pill can be put in place by issuing an interim dividend of the warrants which does not require shareholder approval.[19] The decision to refuse to approve the bidder or to redeem the warrants is a decision solely for the board.

The value dilution resulting from triggering a pill means that no bidder ever crosses the threshold and triggers the pills. Pills are never triggered. They represent, therefore a very potent defensive tool that has the distinct advantage of

---

[17] For example, the Delaware General Corporation Laws, s 203, providing for a business combination statute preventing *ex-post* merger or amalgamation of the target or its assets unless in effect the pre-bid board approved of the bidder's takeover.

[18] We ignore business combination defences that prevent the combination of the target with the bidder after a successful bid unless the target board approves the passing of a specified ownership threshold by the bidder (see for example, Delaware General Corporation Law, s 203). Although they are potent defences (second only to the pill) and place the power in the board to control the defence they are put in place either by a specific takeover statute (and therefore of no comparative relevance for us) or by shareholder amendment to the constitution.

[19] Delaware General Corporation Law, s 157.

not affecting the company at all – no assets or shares are sold or deployed. However, as has become clear in recent years, the potency of the pill is not dependent solely on the ability of the board to create a pill without asking for shareholder approval. As the board can approve of the bidder crossing the threshold or can redeem the pill outright to enable the bid to proceed, it is the resistance of the board, not the pill, that prevents a hostile bid from proceeding. Accordingly, launching a proxy fight to remove the board places considerable pressure on the target board to capitulate. If they do not, and the proxy fight is successful, the removal of the board and the appointment of members favourable to the bidder enable the bid to proceed. However, there is a small US hiccup in the logic of this response: namely the assumption that a shareholder meeting can be called against the will of the resisting board and, once called, that a majority of the directors can be removed. In many Delaware corporations this assumption would not be well founded: shareholders only have a right to call a meeting if the constitutional documents provide for this,[20] and in many corporations they explicitly deny it; and if a meeting can be called, or if the bid is timed in close proximity to the annual shareholder meeting, many corporations have a staggered board which means that only a third of the board come up for re-election each year, and the remainder can only be removed at that meeting with cause,[21] which is a high bar involving some form of illegality or breach of duty.[22] It is, therefore, the basic rules of Delaware corporate law that render the pill potent; in the absence of such a basic rule set the pill's potency is significantly compromised.

1.2.2 Equity restructuring

A longstanding mechanism for making it more difficult for a hostile bidder to acquire a company is to issue a significant block of shares to a friendly third party. Whether such a defence is available to the board depends upon whether the board must obtain shareholder approval to issue the shares or shareholder approval to issue the shares non-pre-emptively. In the United States the only restriction on issuing shares is that the corporation has sufficient authorised share capital to issue the shares.[23] If it does not then shareholder approval would be required to raise the corporation's authorised share capital, and the shareholders would then receive a say in whether or not they wished to approve of the defensive measure. However, most Delaware corporations have a significant reservoir of authorised share capital sufficient to enable a defensive share issuance without having to obtain shareholder approval. Nevertheless, it is important to observe that where the share issuance, although significant, leaves the new shareholder with less than

[20] ibid, s 211(d).
[21] ibid, s 141(k)(1).
[22] *Ralph Campbell* v *Loews Incorporated* 134 A 2d 565 (del.1957).
[23] Note that if the Delaware Corporation is listed on the New York Stock Exchange the NYSE's Listing manual requires shareholder approval for the issue of shares amounting to more than 20 per cent of the outstanding shares at the time of issue. Listing Manual, Rule 312.03(c).

a majority of the shares, whilst the share issuance reduces the probability that the hostile bidder will succeed it is by no means guaranteed to thwart the bid. This was seen most clearly in the UK in the late 1950s when in response to unwanted attention of TI Reynolds, British Aluminum Ltd issued shares amounting to a third of its share capital to the Aluminum Company of America. TI Reynolds proceeded to successfully obtain control of the company.

Hostile takeovers can also be deterred or frustrated by buying back or issuing shares. Buy-backs have two potential defensive purposes. First, the company could buy-back the shares of the hostile bidder at a premium: a 'bribe' to make the bidder go away. This defence is often referred to as 'green mail'. Secondly, a buy-back can be used to enhance the economic interest and voting power of a friendly shareholder or insider. A buy-back in which the friendly shareholder or insider does not participate would increase such shareholder's proportionate stake, reducing the probability of the hostile bid's success. Such a buy-back could also give friendly third parties or insiders a blocking majority in relation to important shareholder votes (such as changing the articles of association) or bidder rights (such as a squeeze-out right). In a Delaware corporation the board is empowered by the Delaware General Corporation Law to buy-back shares.[24] There is no requirement to obtain shareholder approval.[25]

1.2.3 Asset sales crown jewel defences

Asset sales as a takeover defence have a long pedigree in the United Kingdom,[26] and the United States. How this defence functions is straightforward. If the primary or significant objective of the bidder's hostile bid is obtain control of a particular asset or division of the business then a simple way of making the bidder go away is to sell the asset either absolutely or contingently – if the bidder obtains control of the company. In practice, however, asset sales many be difficult to deploy as core assets may not be separable from the rest of the business without damaging the business. Contingent sales may deter the bid and therefore avoid the need for separation, but it may be difficult to find a third party willing to enter into such an arrangement. A contingent sale to an insider risks falling foul of self-dealing rules. A board of a Delaware corporation may sell corporate assets without obtaining shareholder approval provided that the sale does not involve all or substantially all of the corporation's assets.[27]

[24] Delaware General Corporation Law, s 160.

[25] Today green mail is rarely seen in the United States. There are multiple reasons for this including anti-green mail charter amendments, the poison pill, and disadvantageous income tax treatment. Internal Revenue Code, s 5881. See D. Manry and D. Strangeland, 'Greenmail: A Brief History' (2001) 6 *Stanford Journal of Law, Business and Finance* 217.

[26] See n 15 above.

[27] Delaware General Corporation Law, s 271.

1.3 THE BUILDING BLOCKS FOR EFFECTIVE BOARD CONTROLLED TAKEOVER DEFENCES

The US experience points to two preconditions to the availability of board controlled takeover defences and to a further precondition to their effectiveness. The first precondition to availability is that the applicable corporate law enables these defences to be put in place without obtaining shareholder approval. We refer to this precondition as the 'formal availability' pre-condition. The second pre-condition is that, in relation to those defences that are formally available, general corporate law rules on the exercise of board power do not restrain, or excessively restrain, the use of those defences. In the United States, for example, the generally applicable corporate legal constraint on their use is a loyalty-based constraint. The courts will subject the defence to a standard of review designed to test the director's loyalty. This standard is the well-known enhanced scrutiny standard originally set forth *Unocal Corporation* v *Mesa Petroleum,*[28] which requires that that the directors identify a threat and establish a rational basis for that threat (the identification of a threat to corporate policy and effectiveness) and that the actions taken by the board are indeed responsive and proportionate to that threat (that the defensive action is reasonable in relation to the threat posed).

The precondition to a formally available takeover defence's effectiveness is that the basic corporate law rule set does not undermine its potency in practice. In Delaware, for example, the pill would be a much less potent creature if the shareholders in a Delaware corporation had a mandatory right to call a shareholder meeting and mandatory rights either to remove the board or instruct the board to remove the pill.

1.4 LEGAL STANDARDS AND THE UNEXPECTED

In this article we measure the scope for effective takeover defences by reference to the set of board controlled takeover defences that have been deployed in the United States. Our German, Italian, and UK corporate law analysis directly addresses these types of defences. Commentators have argued that a primary benefit of the broad and general board neutrality rule is that it prevents the use of board controlled takeover defences that we currently cannot envisage and which may be compliant with corporate law.[29] This argument suggests a critique and limitation of our defence-specific analysis: whether known takeover defences are trivial in our selected jurisdictions does not address the potential significance of the board neutrality rule in relation to those future, currently unforeseeable defences.

---

[28] 493 A2d 946 (Del. 1985).
[29] Davies, et al, n 10 above, 4-5.

In our view, for two compelling reasons, the strength of this argument is overstated. First, as we shall see in our analysis, in some jurisdictions, including the UK and Germany, broad rules that cover any board defensive actions are provided by corporate law – rules that are no less broad than a board neutrality rule. Secondly, whilst it is indisputable that a broad rule enables the regulation of future, currently unforeseeable, problems, in our view there are very good reasons to think that the future of board controlled takeover defences has no surprises in store. The United States has provided a largely unrestricted laboratory for the innovation in takeover defences. The innovation has continued unabated for over a 30-year period. This innovation has given us: the flip-in pill, the flip-over pill, and the dead-hand and no-hand pills;[30] a vast array of complex restructuring defences; and a long list of shareholder repellents in companies' constitutional documents ranging from fair price rules,[31] disgorgement rules,[32] control acquisition rules,[33] to business combination rules.[34] Innovations driven by strongly incentivised advisors have been subject only to two constraints: loyalty,[35] and non-contravention of the statutory authority to manage and direct the company.[36]

Two strong arguments can be made in opposition to this view. The first is that each corporate legal jurisdiction is systemically distinctive and, therefore, the product of innovation in one jurisdiction tells us only a limited amount about the possibilities of innovation in another. As, for example, hostile takeovers have never been a part of the German corporate governance landscape, what would 30 years of innovation generate with the tools provided by German corporate law? We cannot know. However, relativism cannot completely tie our hands. From what we know about the corporate laws of different jurisdictions, Delaware boards, along with German boards, are situated at the board power/supremacy of a board/shareholder power spectrum. Furthermore, board controlled takeover defences are fashioned using corporate powers made available to boards: the power to issue shares and derivatives and to repurchase those shares and derivatives; the power to buy and sell assets; the power to spend and distribute

---

[30] A dead hand pill allows the redemption of the pill only by the directors who put the pill in place, even if they have been removed; a no-hand pill prevents redemption by newly appointed directors for a specified period of time. See, for example, *Carmody* v *Toll Brothers, Inc* 723 A2d 1180 (Del. Ch. 1998) and *Quickturn Design Systems* v *Mentor Graphics Incorporation* 728 A2d 25 (Del.Ch.1998).

[31] Rules that require the bidder in a two-tier offer to pay the same price at the back end as at the front end.

[32] Rules that provide for the disgorgement of any profit made by an unsuccessful bidder when selling his shares after the failed bid. See, for example, the disgorgement provision in the Pennsylvania Corporation Law, 15 PA. Cons. Stat. Ann, ss 2571-2576.

[33] Control share acquisition defences, whether in the charter or in a takeover statute, prevent an unapproved bidder from voting purchased shares until the remaining shareholders authorise the voting of his shares.

[34] See n 17 above for a description of such a defence which may be provided by state takeover statute or placed in the corporation's charter.

[35] The loyalty standard is the Unocal enhanced scrutiny test set forth in *Unocal Corporation* v *Mesa Petroleum* 493 A2d 946 (Del. 1985).

[36] In Delaware this is set forth in the Delaware General Corporation Law, s 141(a). See *Carmody* v *Toll Brothers, Inc* 723 A2d 1180 (Del. Ch. 1998) and *Quickturn Design Systems* v *Mentor Graphics Incorporation* 728 A2d 25 (Del.Ch.1998).

corporate assets. These are the powers available to boards in most jurisdictions. Indeed, as we will see in our analysis, the powers of US boards are in many respects greater than their counterparts in other jurisdictions. For these reasons, the claim that the US has acted as a universalist laboratory of takeover defences, and what it has not discovered no other jurisdiction will, is more than plausible. A second argument in opposition to this view, is that innovation in the United States has been crowded out by the effectiveness of the pill as a defensive technique: that is, the pressure to innovate was dampened by the existence of such a potent tool. But as is clear from the above analysis this is not correct for all companies. The pill's potency is a function of the rules governing board removal which, in Delaware, is dependent on whether the board is staggered. Although many companies have staggered boards, a significant proportion do not,[37] and those without one lack a defensive mechanism that approaches the potency of the pill/staggered board combination. Target boards of those companies have strong incentives to innovate, and indeed they have, with limited success, continued to do so through dead-hand and no-hand pills that attempt to restrict the redeemability of the pill by a newly appointed board.

Of course one must never say never, but in our view innovation has largely run its course and now operates *within* established defence types – for example looking at the different ways in which you could put a pill in place or providing functional substitutes for the dilutive effect of a pill – and has not for some time provided a new and effective type of defence. Imaginable defence types appear to be one of the few areas of corporate law where history may have reached an endpoint.

2. IS THE UK'S NON-FRUSTRATION RULE TRIVIAL?

In contrast to Germany and Italy, the UK has long had a board neutrality rule and has not altered its position as a result of the implementation of the Directive. The non-frustration rule remains mandatory and is not subject to a reciprocity qualification. From the viewpoint of those committed to a harmonised mandatory neutrality rule, the UK's position supports the efficient integration of European business, protects shareholders, and upholds shareholder sovereignty. In implementing the Directive, had the UK changed its mind and, like Italy, opted to revoke the non-frustration rule, the UK would have entered the opposing side of the post-Directive impact assessment and would be an example of the way in which the Directive has actually undermined single market integration and

[37] As of 1998 a study that looked at 2,421 large companies found that 59 per cent of them had staggered boards. V.K. Rosenbaum, *Investor Responsibility Research Center: Corporate Takeover Defenses* (1998).

shareholder protection and sovereignty. In the context of the UK, any impact conclusions based on the UK's adoption of the neutrality rule are incorrect. The effects on market integration and shareholder sovereignty of the UK's adoption of the rule are trivial. Had it chosen to change its mind and on implementation revoked the neutrality rule, it would have made no significant difference to a UK company's defensive capability. To see this we consider the availability of board controlled takeover defences in a UK world without the non-frustration rule.[38]

2.1 FORMAL AVAILABILITY

2.1.1 A UK poison pill?

A poison pill or shareholder rights plan could be put in place in the UK; however, to do so would require specific shareholder authorisation. The board of a UK company is typically authorised through its articles of association, its primary constitutional document, to issue an interim dividend provided that it has sufficient profits available for distribution.[39] Most companies' articles do not require the shareholders to authorise such a distribution. However, under UK company law, since the implementation of the Second European Company Law Directive,[40] boards cannot grant rights to buy shares without having obtained shareholder authorisation to grant those rights.[41] Most listed companies will provide annual rolling grants of authority to allot shares and, often, although not as commonly, to grant rights to subscribe for shares.[42] Typically such rolling grants of authority enable an issue of shares of up to one-third of the existing outstanding ordinary shares. However, the option grant for a poison pill would necessarily have to be much larger than this, as one warrant would have to be granted for each share. Accordingly the board would require specific shareholder approval to grant the warrants. Such approval would clearly have to explain to the shareholders why it was sought. However, in contrast to the non-frustration principle such authorisation could be given *ex-ante*. With regard to the rights that attach to the warrants most companies' articles empower the directors to set the

---

[38] For a consideration of this issue in the UK context, see D. Kershaw, 'The Illusion of Importance: Reconsidering the UK's Takeover Defence Prohibition' (2007) 56 *International and Comparative Law Quarterly* 267.

[39] We assume here that there will be sufficient distributable profits for the distribution given the value of the option on issue. See Model Articles for Public Companies, art 70.

[40] Second Council Directive 77/91/EEC.

[41] Companies Act 2006, s 549.

[42] Compare Vodafone Plc's 2010 Annual General Meeting resolution in this regard (referring to grants) at <http://www.vodafone.com/content/dam/vodafone/investors/annual_general_meeting/2010_review_of_the_year_and_notice_of_agm.pdf> with Marks and Spencer Plc's rolling grant resolution (referring only to allotment) at <http://corporate.marksandspencer.com/documents/specific/investors/AGM/f0ca5adec426451b9d268155f8053541/2010_Notice_of_Meeting>.

terms of the warrant as 'as they think proper'.[43] As one warrant is issued for each share there is no concern with pre-emptive rights.[44]

One concern about poison pills that is often identified by non-US corporate observers is the pill's apparent discrimination between shareholders, or more precisely between the bidder and other shareholders. In the United Kingdom, claims that a pill is invalid because it is discriminatory are unlikely to be successful. UK company law does not require the board to treat shareholders equally but to have regard to their fair treatment when acting.[45] The Listing Rules which are applicable to listed companies go further than this by requiring in Principle 5 of the Listing Rules that the listed company 'treats all holders of the same class of [shares] that are in the same position equally in respect of the rights attaching to such [shares]'.[46] In our view this requirement would not impinge on the ability to put in place a poison pill. A pill does not discriminate between shareholders; rather it gives holders of shares a right that is conditional on the fulfilment of the warrant's contractually specified conditions. A bidder who crosses the trigger threshold has not complied with those conditions and therefore cannot exercise the rights. Furthermore, any differential treatment does not apply to the rights 'attaching to [the bidder's] shares'; rather it applies to a separate right to buy shares.

Accordingly, UK corporate law would enable a poison pill to be put in place, which formally at least, would give the board the power to approve or not approve of a particular bidder. Such a pill would, however, require shareholder approval.

2.1.2 Equity restructuring

In the UK an equity restructuring defence that involved issuing shares to a friendly third-party would be subject to significant shareholder control, rendering it in effect formally unavailable without shareholder support. As noted above an issue of shares requires that the shareholders in general meeting have granted authority to allot the shares.[47] Such authority is granted by an ordinary resolution (a simple majority of the votes cast at the meeting). Shareholders commonly provide for rolling grants of authority for substantial blocks of shares, typically in the range of a third of the issued shares. Such a block would be large enough to significantly decrease the probability of success for a hostile bid. However, in addition to requiring authority to allot the shares, an issue to a third party is a non pre-emptive issue and requires that shareholders waive their pre-emption rights which are

---

[43] See for example Vodafone Group Plc Articles of Association, regulation 11.1 (2010) at <http://www.vodafone.com/content/dam/vodafone/investors/corporate_governance/vgplc_articles_2010_agm.pdf>.

[44] Companies Act 2006, s 561(3) applies pre-emption rights to the grant of an option but not in relation to the allotment of shares in exercise of the option.

[45] Companies Act 2006, s 172.

[46] The Listing Principles are set forth in Listing Rule 7.2.

[47] In any event pursuant to the Companies Act 2006, s 564, pre-emption rights do not apply to a bonus issue of shares.

provided by section 561 of the Companies Act 2006. Such rights must be waived by a special resolution (75 per cent of the votes cast at the meeting).[48] However, pre-emption rights are not applicable in relation to any issue of shares where any part of the consideration is non-cash consideration.[49] Furthermore, as with the authority to allot shares or grant options, shareholders of listed companies typically approve significant pre-emption right waivers on an annual basis without there being any specified purpose for the waiver. For example, Vodafone Plc at its 2010 annual general meeting granted a pre-emption right waiver in relation to up to 19 per cent of its shares.[50]

Such waivers appear to enable significant board controlled non-pre-emptive issues of shares to friendly third parties. Such issues would clearly have an impact upon the probability of success for the hostile bidder. Accordingly, it could be argued that whilst formally shareholders appear to control share issues, in practice they relinquish that authority to the board in relation to potentially large blocks of shares. This would appear to give the board significant scope to deploy an equity restructuring defence without seeking *ex-post* shareholder approval and when the *ex-ante* approval given did not amount to a consent to their defensive use. In practice, however, there is a significant amount of informal shareholder control over share issues in the UK. Institutional shareholders are very fond of their pre-emption rights. This is clearly evidenced by the formation in 1987 of the Pre-Emption Group, an informal regulatory body that specifies guidelines for companies and investors on pre-emption right waivers. The guidelines specify that in any one year that there should be no greater than five per cent non pre-emptive issues and no more that seven point five per cent over a three-year period.[51] This dramatically reduces the shares available for non pre-emptive issues when compared to the actual rolling waivers. Directors could of course ignore these informal guidelines and in a defensive context issue a much larger block of shares. However, any widespread abuse by companies of rolling pre-emption waivers for defensive purposes would almost certainly result in adjustments to the approvals and the guidelines. This could take the form of reduced rolling waiver percentage figures, to the five per cent recommendation or below, or keeping larger rolling waivers in place and imposing conditions on the authorisation to allot the shares: for example, no issue is permitted once a bid is imminent or has commenced.[52]

As regards share buy-back defences UK company law requires shareholder approval to carry out a buy-back. The nature of that approval varies depending upon whether the buy-back is purchased 'on-market' through a recognised investment exchange or 'off-market' with specified shareholders. In relation to an

---

[48] For a public company pre-emption rights can be waivered by a waiver resolution or by a resolution amending the article to that effect. ibid, s 570. Private companies can opt out of the pre-emption regime altogether by providing for an opt-out in their articles. ibid, s 567.
[49] ibid, s 565.
[50] Resolution 20 2010 Annual General Meeting, n 42 above.
[51] Pre-Emption Group, *Disapplying Pre-Emption Rights – A Statement of Principles* (2008), paras 8, 10.
[52] Companies Act 2006, s 551(2), provides for the inclusion of condition on the allotment authorisation.

on-market purchase approval by a simple majority of the votes cast is required.[53] This general authority may be given for a period of 18 months.[54] Accordingly, if pre-approval has been given this does give the board some scope to enhance the size of friendly shareholders during a hostile bid. However, the approval must specify a limit on the number of shares being repurchased, and as most UK listed companies do not have large shareholders, such repurchases are unlikely to significantly alter the balance of power in a takeover bid.

If the repurchase is an off-market purchase, such as the repurchase of a block of shares from one shareholder – which could be used as a green mail defence – then a special shareholder resolution is required following disclosure of the sale contract.[55] The selling shareholder and any of his associates are not allowed to vote their shares.[56] Accordingly a green mail defence requires contemporaneous disinterested shareholder approval.

2.1.3 Asset sales/crown jewels defences

Of our three defence types, asset sales are the least potent. In addition to the problem of finding buyers for substantial assets and the difficulties, from buyer's perspective, of carrying out due diligence and negotiating the sale within the time constraints of a UK takeover offer,[57] many of the company's assets will not be detachable from the other assets without damaging the company's business. However, notwithstanding these limitations, an asset sale of a substantial amount of the UK company's assets is clearly formally available to the board without shareholder approval. The Companies Act 2006 does not address the issue of board power in this regard or the approvals required to sell assets. This is a matter for the articles of association. Typically in large companies the shareholders will not reserve power in relation to the sales of assets or transactions of a particular size, although it is clearly open for them to do so. From a company law perspective, therefore, board power in relation to sales of assets may well be unlimited. However, where the company is a listed company the United Kingdom Listing Authority's Listing Rules require shareholder approval for any transaction that amounts to a Class One transaction which in effect requires shareholder approval for any transaction that has a value of more that 25 per cent of the company's value.[58] This means that sales of assets which amount to less than 25 per cent of the company's value can be sold without shareholder approval. Formally, therefore, in the absence of the non-frustration rule asset sales of less

[53] ibid, s 701(3).
[54] ibid, s 701(5).
[55] ibid, s 694-699.
[56] ibid, s 695.
[57] Pursuant to the Takeover Code an offer could be commenced and closed within a 21-day period. Rule 31.1. Typically the offer period will extend beyond this date. For a typical bid timetable, see D. Kershaw, *Company Law in Context* (Oxford: OUP, 2009), Web Chapter A: 'The Market for Corporate Control', 93-95 at <http://www.oup.com/uk/orc/bin/9780199215942/resources/01chapters/>.
[58] Listing Rule 10.

then 25 per cent of the company's value would be an available board controlled takeover defence. Indeed they represent the only defence that may be deployed without any shareholder involvement.

2.2 General corporate legal restraints on the use of board controlled defences

In the United Kingdom directors are not empowered by the corporate statute, as is the case in most jurisdictions,[59] but rather are empowered by the shareholders who delegate authority to the board through the articles of association,[60] which the shareholders alone have the power to alter. Directors are subject to fiduciary duties which require them to exercise the delegated powers loyally.[61] In the United Kingdom, prior to 2006 the common law obligation of loyalty in relation to the exercise of corporate power was the duty to act in good faith in the best interests of the company.[62] The Companies Act 2006 codified this obligation, which is now the duty to promote the success of the company.[63] The codified duty, as with its predecessor duty, imposes a subjective standard on a director to do what *she* considers is in the company's interests. As our minds are closed to accurate judicial inspection, in application this standard is a rationality or plausibility standard: the director must show only that there is a rational basis for the decision in order to comply with the standard.[64]

If the duty to promote the success of the company was the only general regulation of the exercise of corporate power, then UK company law would impose virtually no restraint on the use by boards of the formally available defences which we have identified in Part 2.1 above. A rational explanation is always available for the exercise of board controlled takeover defences. Such a rational explanation could include the need to facilitate an auction or to enhance the board's bargaining power to ensure that shareholders obtain the best price; or even to prevent the success of the bid as neither the shareholders nor the market understands the true value of the company. However, the duty to promote the success of the company is not the only general applicable restraint provided by UK company law.

A common law doctrine of English law, of longstanding heritage, known as the improper purpose doctrine, imposes a rule-based restraint on the use of takeover defences which is remarkably similar to the Takeover Code's non-frustration rule. This rule provides that corporate powers formally available to the

---

[59] In a Delaware corporation the board is empowered by the Delaware General Corporation Law, s 141(a); the management board of a German Aktiengesellschaft is directly empowered by the German Stock Corporation Law, s 76; the Italian Civil Code, art 2380*bis* directly empowers the board of an Italian company.

[60] See, for example, the Model Articles for Public Companies, art 3.

[61] cf M. Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Oxford: Hart, 2010).

[62] *Re Smith & Fawcett* [1942] Ch. 304.

[63] Companies Act 2006, s 172.

[64] *Regentcrest* v *Cohen* [2001] 2 BCLC 80; *Re Saul D Harrison & Sons Plc* [1995] 1 BCLC 14.

board cannot be used to intentionally interfere with a takeover offer without having obtained shareholder approval to do so. In contrast to the Takeover Codes' non-frustration principle, where shareholder approval must be obtained *ex-post* the immanency or commencement of the bid, under the improper purpose doctrine either *ex-ante* or *ex-post* approval would suffice.[65] Importantly for understanding the scope for the board to deploy takeover defences in the UK it is important to stress that this is a generally applicable rule, it is not a loyalty-based standard that attempts to determine whether the board has exercised the power loyally.[66]

The improper purpose doctrine does not have its roots in the takeover defence context but in cases where boards of directors used corporate power to interfere with voting control in the shareholder meeting. UK courts consistently invalidated such actions using a constitutional balance-of-power/shareholder rights-based theory of invalidity. In the 1864 case of *Fraser* v *Whalley*,[67] for example, the board of directors issued shares to friendly third parties in order to dilute the holdings of a substantial shareholder. The directors claimed their actions were lawful as they were acting loyally in defence of the company's interests. The court rejected this argument holding that the issue of shares for interfering with voting control was not a purpose for which the power had been 'entrusted' to the board. Formally the board had the authority to issue the shares but the court imposed implicit limitations on the delegation of that authority – it could not be used for the purpose of interference with voting control or, as the court put it: 'to deprive him of his rights'. For the court in *Fraser*, voting control was so fundamental to shareholders that they could not be deemed to have authorised the board to intentionally interfere with their voting rights unless they had explicitly authorised such interference.

In subsequent cases this theory of fundamental constitutional rights was extended to the hostile takeover context. In 1953, following an unsolicited approach to purchase the Savoy Group, the target's board put in place a sale and leaseback arrangement for one of its premier hotels, The Berkeley, in order to deter the bid. Although this case never made into the court room it did result in a Government instigated investigation by a leading QC, who found that the actions of the target board were not, in his view, a lawful exercise of its authority:

---

[65] Interestingly, one could argue that such a rule allowing for *ex-ante* approval is consistent with the Takeover Directive and, therefore, that the improper purpose doctrine accurately implements the Directive. The stronger reading of the Directive implies *ex-post* approval. However, a literal reading of the provisions would allow for *ex-ante* approval. The Directive does not explicitly say the meeting granting approval has to be after the bid has commenced.

[66] Note, however, that the rules itself involving a prohibition subject to shareholder approval is structurally the same as the UK loyalty-based prohibitions on self-dealing and corporate opportunities, which also are not concerned with loyalty in fact but rather with the possibility of conflict. See further, D. Kershaw, *Company Law in Context: Text and Materials* (Oxford: OUP, 2009), chs 13, 14.

[67] [1864] 71 E.R. 361 (Ch. D. 1864).

> [However] proper the motive behind [the sale and leaseback], it is not a purpose for which those powers *were conferred* on the Board. *Powers conferred by the shareholders on directors* for the purpose of managing the business of the Company cannot be used for the purpose of depriving *those shareholders* of [their residual] control over the Company's assets (emphasis added).[68]

A decade later in the case of *Hogg* v *Cramphorn Ltd*,[69] the issue of the intentional use of corporate power to defeat a hostile takeover by a bidder who was not a substantial shareholder was addressed by the courts for the first time. In this case, in order to repel a bid that the board viewed unfavourably, the board set up a trust for the benefit of the employees and issued shares and made a loan to the trust. The trust's trustees consisted of the company's CEO, the company's auditor, and an employee representative. The objective of issuing the shares was to prevent the bidder from controlling the company should he launch a successful takeover bid. The objective of the loan was to enable the trust to buy shares from the shareholders at the same price the bidder was proposing, if any shareholders felt aggrieved at having lost out on the opportunity to exit their investment. An action was brought by an affiliate of the potential bidder having acquired a nominal number of shares. The court found that both the issuance of the shares and the loan were unlawful in the absence of explicit shareholder approval. Although the court found that the directors were acting in good faith in what they believed to be in the company's best interests, and although the court accepted that formally the board had the power to issue the shares and make the loan, the court held that such actions amounted to illegitimate interference with the shareholders' fundamental constitutional rights. The law did not 'permit directors to exercise powers *delegated to them* […] in such a way as to interfere by the majority with the exercise of its constitutional rights' (emphasis added). Constitutional rights were understood by the court to mean the right to non-interference with voting control and the right to non-interference with the decision as to whether or not to accept an offer for the shares. Such interference could only take place if the shareholders had explicitly authorised it. Furthermore, the Court explicitly noted that any reasons given for such actions, no matter how compelling and honestly believed, were 'irrelevant'.

In the early 1970s the Privy Counsel in *Howard Smith Ltd* v *Ampol Petroleum Ltd,* affirmed the position in *Hogg* v *Cramphorn Ltd.* Although the case concerned the issue of shares to alter the control structure in the company, Lord Wilberforce made some important observations on the use of board power to interfere with a possible hostile bid:

> The right to dispose of shares at a given price is essentially an individual right to be exercised on individual decision and on which a majority, *in the absence of*

[68] See The Savoy Hotel Limited and the Berkeley Hotel Company Limited: Investigation under Section 165 (b) of the Companies Act, 1948: Report of E. Milner Holland (1954), 27.
[69] [1967] Ch. 254.

> *oppression or similar impropriety*, is entitled to prevail. Directors are of course entitled to offer advice, and bound to supply information, relevant to the making of such a decision, but to use their fiduciary power solely for the purpose of shifting the power to decide to whom and at what price shares are to be sold cannot be related to any purpose for which the *power over the share capital was conferred upon them* (emphasis added).[70]

For Lord Wilberforce the shareholder has a right to decide whether or not to sell his shares in response to a takeover offer, and the board has no authority to intentionally interfere with the exercise of that right. The delegation of power from the shareholders to the board to manage the company does not extend to the authority to take such action. For the board to be able to do so requires explicit (*ex-ante* or *ex-post*) shareholder approval. This is a general rule applicable to any exercise of corporate power. A small exception to this is noted by Lord Wilberforce, as it was in *Hogg* v *Cramphorn Ltd*: such actions may be taken to prevent 'oppression or similar impropriety'.

The legal principle that powers must be used for purposes for which they are conferred was codified in section 171(b) of the Companies Act 2006 as a duty to use corporate powers for proper purposes. Its codification as a duty is somewhat peculiar as the cases which it codifies do not refer to it as a duty;[71] it was not enforced derivatively but rather as a personal right;[72] and the broad idea of using powers for proper purposes is not a standard-like starting point for the analysis,[73] but a basis for explaining a constitutional rule which sets forth a default division of power in relation to questions of voting control and hostile bids. Importantly, its codification as a duty does not affect its straightforward rule-based characteristics: board action that intentionally interferes with voting control is unlawful without *ex-ante* or *ex-post* shareholder approval.

Arguably in one important respect this rule is different than the non-frustration principle in that it relies on the court to determine the purpose for which the action was taken. If the substantial purpose of the board action is not to interfere with the shareholders' constitutional rights then the action is lawful. By contrast the non-frustration rule is a rule that prevents any action that could frustrate the bid (without shareholder approval) regardless of whether the board would wish to take such action for reasons unrelated to the bid. This is a distinction, however, of limited import. The most powerful defences such as poison pills do not have any non-defensive purpose and in relation to those that

---

[70] [1974] 1 All ER, 1133.

[71] Some commentators view the doctrine as a sub duty of the duty of loyalty. See P. Davies, *Gower and Davies Principles of Modern Company Law* (UK: Sweet & Maxwell, 7th ed, 2003). In our view this is incorrect. As the analysis below shows it is a doctrine based on the distribution of power in the corporation. Very few pre-2006 cases used the term duty to refer to the doctrine. See *Re BSB Holdings Ltd (no.2)* [1996] 1 BCLC 155. Clearly the doctrine is elevated to a duty in The Companies Act 2006, s 171(b).

[72] See *Hogg* v *Cramphorn* [1967] Ch. 254 and *Re Sherborne Park residents Co Ltsd* [1987] BCLC.

[73] Arguably it was in *Howard Smith* but not in any of the earlier cases.

do, for example share issues or asset sales, boards will struggle to persuade a court that sudden non-ordinary course transactions were taken for a 'legitimate corporate purpose' and that interference with the shareholder's constitutional rights was only an ancillary effect.

In our view the above analysis accurately reflects UK law today. However, there are two post-*Howard Smith* cases that arguable qualify the above position that need to be addressed. In the unreported High Court case of *Cayne* v *Natural Resources*,[74] a case that involved the issue of shares that the plaintiffs claimed was aimed at influencing the result of a proxy contest, Vice Chancellor Megarry observed that the rule set forth in *Hogg* v *Cramphorn Ltd* 'must not be carried too far'. What Megarry VC meant by this statement is that the strictness of the rule should not be understood to prevent all board action taken to protect its shareholders. Whereas *Hogg* suggests that reasons for action are 'irrelevant', Megarry VC questions whether that is always the case. The example that animates his observations is where a competitor of a company takes an equity position in the company for the sole purpose of damaging the company, in order to enhance its own competitive position. The law cannot, Megarry VC opines, require the board to remain passive where the company is threatened with being 'reduced to impotence and beggary'.

The second case is *Criterion* v *Stratford Properties LLC*.[75] In this case the board of Criterion, in response to a rumoured bid from an unwanted predator, put in place a defensive amendment to its joint venture agreement with Stratford. The amendment provided that Criterion would buy-out Stratford at a guaranteed 25 per cent premium if the defence was triggered. There were two triggers to the defence: either a successful takeover of the company (by any bidder); or the removal of the Chairman or CEO of the company. The rumoured bid never materialised. However, at a subsequent date the defence was triggered as a result of the removal of the CEO, at which point Stratford brought an action to enforce their sell-out right. At first instance and the Court of Appeal the legal question was whether entering into such an arrangement was a lawful exercise of corporate power. The High Court held that the defensive arrangement was unlawful as it was so disproportionate to the purported threat. However, in holding that the board's action was invalid Hart J suggested that UK company law might provide somewhat greater flexibility for boards to interfere with the shareholder right to accept or reject a takeover offer. Hart J at first instance, relying on *Cayne* v *Natural Resources* and a Canadian case,[76] suggested that such action might be lawful if a reasonable director would view the 'economic damage' to the company as justifying the board's actions. The Court of Appeal considered the case but refused to decide whether, and if so under what circumstances, board controlled defensive action *could* be lawful. In the Court of Appeal's view if intentionally defensive measures were *per se* unlawful, then the actions in this case were

[74] Unreported (Lexis).
[75] [2002] EWHC 496 (Ch).
[76] *Teck Corporation* v *Millar* [1972] 33 DLR (3d) 288.

necessarily unlawful, but even if such measures were lawful in theory, in this particular case the board's actions were so disproportionate to the alleged threat that they could not plausibly have been taken in the corporate interest. Accordingly the Court of Appeal thought it was unnecessary in this case to decide whether defensive measures could ever be lawful.[77]

To what extent is the position set forth in *Hogg* v *Cramphorn* and *Howard Smith* altered by these cases? With regard to *Cayne*, one might ask whether 'impotence and beggary' differs in any significant respect from the 'oppression and *similar impropriety*' exception referred to in *Howard Smith*. Furthermore, Megarry VC in *Cayne* is really concerned that the strictures of the *Hogg* rule may prevent the company from protecting itself from extremely abusive minority shareholder behaviour. What he appears to forget however, is that the rule in *Hogg* permits shareholders by ordinary resolution to approve protective board action, which they surely would do in the circumstances he describes. Perhaps the protective rationale Megarry VC refers to would support board action where time is of the essence and where there may not be enough time to call a meeting. It is however difficult to imagine circumstances in the voting control context where such flexibility would be necessary and, it is submitted, impossible to imagine in the context of a hostile takeover offer taking place in accordance with the Takeover Panel's process rules (assuming the non-application of rule 21).

Criterion at first instance is a more difficult case for the position articulated in *Hogg* and *Howard Smith* as it clearly expands the scope for reason-based justifications for board action beyond 'oppression and similar impropriety'. In our view the holding of this case is clearly inconsistent with authority: reasons for *Hogg* and *Howard Smith* were irrelevant. However, in the unlikely event that it finds

---

[77] The case was appealed to the House of Lords; however, the House of Lords did not directly determine whether using corporate powers for defensive purposes was a proper corporate purpose. The House of Lords clearly places the question of the legitimacy of the action within the legal question of authority: did the board have authority to use corporate power in this way (see in particular Lord Scott of Foscote's judgment)? The House of Lords held that the lower courts had not considered the issue of authority and directed them to do so. Whether this view of the lower courts judgments is correct is open to dispute. However, for our purposes what is important is that the House of Lord's approach is consistent with the original understanding of the proper purpose doctrine as a rule setting forth the default constitutional division of power in relation to fundamental issues such as the interference with voting control or the right to decide on a takeover offer. However, the House of Lords took no position on the substantive question of when defences could be deployed without shareholder approval. One could argue that the very fact that the House of Lords referred the authority issue (whether apparent or ostensible) back to the lower courts is indicative of the House of Lords' approval of the fact that defences may be deployed without shareholder approval. However, it is important to note that no UK court has said that board action can never, without shareholder approval, interfere with fundamental shareholder rights. Regarding actual authority *Hogg* v *Cramphorn* and *Howard Smith* both accept that the board may take such action to avoid 'oppression or similar impropriety'. With regard to ostensible authority it is possible to envisage circumstances in which the board takes action to interfere with fundamental rights, but the third party is unaware of the voting control or takeover implications of the action, in which case the board would have ostensible authority to take the action. Accordingly, for both *Hogg* and *Howard Smith* it is possible that the board may have actual or ostensible authority, and therefore, no substantive implication can be read into the House of Lords' authority direction. Our thanks to Edmund Schuster for discussion of this point. See *Criterion Properties Plc* v *Stratford UK Properties LLC* [2004] UKHL 28.

future fertile judicial sole it is submitted the scope for board action is very limited. The framework of analysis in *Criterion* is a rights-based framework or a power distribution framework: when can a threat justify interference with the shareholder right to decide to sell. It is a rights-based framework whose only UK judicial support is *Cayne* v *Natural Resources*. Accordingly, a reasonable director through the eyes of a UK court will require something close to impotence and beggary to justify defensive action, and as argued above, in the UK context it is difficult to imagine any such circumstances arising from a hostile bid governed by the Takeover Code. Accordingly, in relation to the limited defences which are formally available to boards of UK companies without requiring shareholder approval, such defences cannot be used in the UK without the board having obtained explicit authorisation from the shareholders to do so. The only notable difference with the non-frustration rule is that such approval can be given prior to the target board becoming aware of any bid.

2.3 PRACTICAL EFFECTIVENESS

An important distinction between company law's regulation of takeover defences and the board neutrality rule is that it is possible under company law to make defences available to boards through *ex-ante* shareholder approval when no bid is on the horizon. Under the non-frustration rule only *ex-post* approval would allow the board to deploy the defence. This means that UK company law enables the attentive and informed shareholder to elect to take the risk that defences may be used to benefit management and not the shareholders. In any such shareholders' view those risks would be outweighed by the potential benefits of defences. Of course, this *ex-ante* flexibility also enables the board to take advantage of rationally apathetic or inattentive shareholders to obtain approval for the construction and deployment of defences without those shareholders having given considered thought to whether making them available is appropriate. There is some support from the United States to suggest that informed shareholders would take this risk,[78] and strong evidence that they would be anything other than apathetic in the face of requests to approve them.[79] We do not have space here to consider this debate in detail and refer the reader to discussion elsewhere.[80] Here we are concerned with the scope for the board to use the defences made available by

---

[78] See M. Klausner, 'Institutional Investors, Private Equity and Anti-Takeover Protection at the IPO Stage' (2003) 152 *University of Pennsylvania Law Review* 755, 760, detailing evidence that a significant majority of Private Equity firms who bring their portfolio companies to market ensure that those companies have a potent staggered board/poison pill defence in place (as poison pills can be adopted after a bidder approaches the company, in effect a company with a staggered board in the US always has a staggered board/poison pill combination).

[79] See Klausner, ibid, detailing the contemporary voting patterns when shareholders are asked to amend the charter to stagger the board. Based on a report from the Investor Responsibility Research Center (2001) *Voting by Institutional Investors on Corporate Governance Issues* 5, Klausner observes that 59 per cent of institutional investors report that they vote against such proposals.

[80] See Kershaw, n 38 above.

shareholders to entrench themselves rather than for legitimate corporate or shareholder regarding objectives.

A widely-held view within the European takeover debate is that if you make defences available to directors then most likely they will use them to further their own interests.[81] However, the scope to use defences to further a manager's own interests in clear disregard of the shareholders' interests is a function of the broader corporate governance landscape in the applicable jurisdiction. As we observed in Section 1 above, the potency of a poison pill in the United States is dependent on the board being a staggered board. As the removal right for a staggered board is a with cause removal right, in order for a hostile bidder to obtain control over the board she must wait for two annual shareholder meetings – removing a third of the board at the first meeting and a third at the second. In the UK the mandatory removal right is a without cause right enabling the removal of the whole board at a single general meeting by simple majority vote and without any need to justify the removal.[82] Furthermore, a general meeting can be swiftly called at any time upon the initiative of the shareholders themselves provided that a group of shareholders representing five per cent of the shareholder body requisitions the board to call a meeting.[83] In many UK listed companies that would require the agreement of only two or three institutional shareholders.[84] Pursuant to UK company law such a meeting could be called within a minimum time period of 49 days.[85] Accordingly, any board that refused to redeem a pill where the shareholders predominantly favoured the bid would be destined for swift removal in order to enable the bid to proceed. In the alternative a shareholder meeting could be called to instruct the board to remove the pill. Such an instruction would require a special resolution (75 per cent of the votes cast at the meeting) but given the low voting rates at general meetings in UK companies such a resolution could be passed with significantly less than 75 per cent of the outstanding shares.[86]

In relation to other possible defences such as the issue of shares which benefit from rolling allotment and pre-emption right waiver approvals, or the use of an asset sale defence, the ability to replace the board to prevent the action or to instruct the board to desist from proceeding would be ineffective as the corporate action could be implemented before a meeting could be called. However, the basic rule set of UK company law still operates as an important constraint on the use of such defences. Any deployment of defences against the wishes of the

---

[81] See n 8 above.
[82] Companies Act 2006, s 168.
[83] ibid, s 303-305, as amended by The Companies (Shareholders' Rights) regulations 2009, no 1632.
[84] On shareholder ownership in the UK, see D. Kershaw, *Company Law in Context: Text and Materials* (Oxford: OUP, 2009), 171-175.
[85] Companies Act 2006, s 304(1), provides that the board must call the meeting within 21 days from the date the meeting was requisitioned and for a date not more that 28 days later.
[86] The Model Articles for Public Companies, art 4, provides an example of such an instruction right. Most listed companies provide for a similar instruction right.

majority of shareholders would risk subsequent removal by those shareholders. In contrast to the United States, in the UK the rules governing the removal of directors and the rules on the calling of shareholder meetings do not guarantee the board a period of time during which shareholder tempers can be cooled. Accordingly, in the UK not only do the use and, typically, the construction of takeover defences require shareholder approval, once made available the scope to deploy them for entrenchment purposes is very limited.

2.4 SUMMARY

The above analysis shows clearly that if the objective of the board neutrality rule is to protect shareholders from managerial abuse or to affirm their sovereignty it is of trivial consequence in the United Kingdom. Its absence would, however, open the door to the increased availability and use of board controlled takeover defences where shareholders *ex-ante* elect to make them available. Importantly, such defensive availability would be an exercise of shareholder sovereignty – one that the board neutrality rule denies them. Whether such an increase in the use of takeover defences would place additional sand in the wheels of the market for corporate control is unclear. On the one hand, where shareholders, having *ex-ante* elected to trust the board by empowering it to use defences, do not challenge their use when a bid materialises then this could inhibit transactions that would have happened but for the removal of the non-frustration rule. However, in the absence of those defences such shareholders would surely in any event have followed management's lead and have rejected what the board told them was an inappropriate offer. On the other hand, where shareholders balk at the deployment of the defences they approved of *ex ante,* then directors, aware of the shareholder friendly context of UK corporate governance and the institutional structure of UK shareholder ownership, are unlikely to aggressively deploy those defences. If this analysis is correct the removal of the non-frustration rule and the possible (shareholder approved) increase in the availability of takeover defences would also have a trivial impact on activity levels in the market for corporate control.

3. IS A BOARD NEUTRALITY RULE TRIVIAL FOR GERMAN COMPANIES?

The central provision of German law addressing the problem of defensive measures adopted by the target's management board is section 33 of the Securities

Acquisition and Takeover Act.[87] The provision was adopted in 2001 and was not altered as a result of the implementation of the Takeover Directive.

There were two primary drivers of the Act's adoption. The first was the rejection of the proposal for a Takeover Directive by the European Parliament in 2001. In anticipation of European legislation and in accordance with the Common Position for the Takeover Directive of 19 June 2000,[88] which in turn was based on the UK Takeover Code,[89] early drafts of the German law had contained a strict non-frustration requirement addressed at both the management and the supervisory board. Following the failure to adopt the proposed Directive, and with the future of the European initiative in doubt, the German legislature was unconstrained by European demands and became more susceptible to voices critical of a broad neutrality principal.[90] The second driver of the Act's adoption was that the German public's view of board neutrality had soured after first proposals for the Securities Acquisition and Takeover Act had been circulated, mainly as a result of the prolonged takeover battle between Vodafone and Mannesmann.[91]

---

[87] Wertpapiererwerbs- und Übernahmegesetz, Law of 20 December 2001 (Federal Law Gazette I p 3822), as last amended by the Law of 30 July 2009 (Federal Law Gazette I p 2479), art 3. s 33 reads: 'Actions of the Board of Management of the Target Company.
(1) After publication of the decision to make an offer and until publication of the result pursuant to section 23(1) sentence 1 no. 2, the board of management of the target company may not take any actions which could prevent the success of the offer. This does not apply to actions which a prudent and conscientious manager of a company not affected by a takeover bid would have taken, to endeavour to find a competing offer, or to actions consented to by the supervisory board of the target company.
(2) If the general meeting authorizes the board of management prior to the period referred to in subsection 1 sentence 1 to take actions falling within the competence of the general meeting in order to prevent the success of takeover bids, such actions shall be specified in detail in the authorization. The authorization may be granted for a maximum term of 18 months. The resolution by the general meeting requires a majority of at least three quarters of the share capital represented at the vote; the articles of association may provide for a larger majority and further requirements. Any actions by the board of management on the basis of an authorization pursuant to sentence 1 shall require the consent of the supervisory board.' [Translation by BaFin.]

[88] Common Position (EC) No 1/2001 of 19 June 2000 adopted by the Council, acting in accordance with the procedure referred to in Article 251 of the Treaty establishing the European Community, with a view to adopting a Directive of the European Parliament and of the Council on company law concerning takeover bids. 2001 OJ C 23/1.

[89] For the text of the German draft version, see L. Röh in W. Haarmann and M. Schüppen (eds), *Frankfurter Kommentar zum Wertpapiererwerbs- und Übernahmegesetz* (Frankfurt am Main: Verlag Recht und Wirtschaft, 3rd ed, 2008), s 33/6.

[90] In particular, trade unions and some industrial undertakings voiced concerns, see H. Krause and T. Pötzsch in H.D. Assmann, T. Pötzsch, and U.H. Schneider (eds), *Wertpapiererwerbs- und Übernahmegesetz* (Cologne: Otto Schmidt, 2005), s 33/17.

[91] After eventual adoption of the Directive, companies were given the option of electing the more restrictive European neutrality rule (Takeover Directive, art 9) by resolution of the general meeting and amendment of the articles. See Securities Acquisitions and Takeover Act, s 33a (the Directive requires that companies be given the opt-in if the Member State does not provide for a mandatory non-frustration principle). See the Takeover Directive, art 12(2). Furthermore, as permitted by the Directive, art 12(3), the German Act contains a reciprocity rule which provides that the general meeting of a company that has adopted the stricter neutrality rule may resolve that these rules shall not apply if the company becomes the target of a bidder that does not operate under corresponding restrictions. s 33c. In that case, the default rule of s 33 governs the takeover. The European breakthrough (Takeover Directive, art 11) is also contained as an opt-in in the German Act, s 33b.

Section 33 prohibits target board defensive action that has not been approved by the shareholders. Approval may be given *ex-ante*, for a period of up to 18 months prior to the commencement of the bid.[92] However, this broad prohibition is effectively nullified by several exceptions contained in section 33. The management board may take actions that are outside the normal course of business without authorisation by the general meeting, even if they have not yet been partly or fully implemented, provided that 'a prudent and conscientious manager of a company not affected by a takeover bid would have taken' the same action.[93] More importantly, defensive action is permissible if consented to by the supervisory board of the target.[94] The board neutrality rule only applies to the management board,[95] which has sole responsibility under German law to manage the company.[96] However, members of the management board and the supervisory board are subject to similar conflicts of interest in a takeover situation: both have private benefits of control that are placed in play by the hostile bid. Translated into the unitary board context, consisting of executive and independent non-executive directors, the effect of the exception is to allow for board controlled defensive measures when the board elects to deploy them.

Accordingly, as has been acknowledged in the literature, the German legislature attached greater importance to the autonomy of directors to assess whether a bid is in the interest of the company and all affected stakeholders, than to the interests of the shareholders in controlling the use of takeover defences.[97] This is in line with the philosophy underlying directors' duties in the German stock corporation. While the Stock Corporation Act is silent on the question of in whose interests directors shall act, the relevant provisions[98] are commonly interpreted as requiring the management board to consider the interests of the shareholders, employees, and society at large.[99] Furthermore, there is no order of priority in relation to these interests. Rather, the board is expected to decide on a

[92] Securities Acquisitions and Takeover Act, s 33(1) sentence 1, s 33(2).
[93] ibid, s 33(1), sentence 2.
[94] ibid. This exception was included in the last stages of the legislative procedure, after the draft Takeover Directive had been rejected in the European Parliament. See H. Krause and T. Pötzsch in Assmann, et al (eds), n 90 above, s 33/17.
[95] s 33(1), sentence 1.
[96] Stock Corporation Act (Aktiengesetz), Law of 6 September 1965 (Federal Law Gazette I p 1089), as last amended by Art 1of the Law of 31 July 2009 (Federal Law Gazette I p 2509), s 76.
[97] Röh, n 89 above, s 33/2.
[98] In particular the Stock Corporation Act, s 76(1).
[99] The Stock Corporation Act 1937, s 70(1), contained an express provision to the effect that the management board shall manage the company 'for the benefit of the undertaking and its employees and as the common good of the people and the Reich requires'. Not only because of its political undertones, but also because the legislature believed that the social obligations of management were self-evident and that an explicit provision was, therefore, unnecessary, this formulation was left out when the Stock Corporation Act was reformed in 1965. See W. Hefermehl and G. Spindler in B. Kropff and J. Semler (eds), *Münchener Kommentar zum Aktiengesetz* (Munich: Beck, 2d ed, 2004), vol 3, s 76/53.

case-by-case basis and is accorded discretion as to how to reconcile the interests where they conflict.[100]

The change in the German Government's stance towards the neutrality rule, and the contentious nature of the political and legal debate[101] leading up to the enactment of Section 33 of the Securities Acquisition and Takeover Act, suggests that the decision as to whether to adopt or reject the board neutrality rule mattered to the defensive capability of the management boards of German stock corporations. Below, following the structure adopted in the other sections of this article, we ask whether this is the case.

3.1 FORMAL AVAILABILITY

3.1.1 A German poison pill?

Shareholder rights plans are not a common takeover defence in Germany. One possible reason for this is that they are not necessary. The German corporate landscape is characterised by large block holdings and cross shareholdings, which insulate many companies from hostile takeovers. In addition, until the reforms of 1998,[102] shares with multiple voting rights and voting caps were permitted, further stifling the market for corporate control.[103] However, notwithstanding these structural impediments to hostile takeovers, another reason why shareholder rights plans have not featured prominently in Germany is because the legislative environment regarding the issuance of naked warrants[104] is less flexible than in the United States, and the freedom of contract required to fashion effective poison pills is more restricted.

Dividend payments can, in general, only be made on the basis of a shareholder resolution deciding on the appropriation of the balance sheet profit.[105] As an exception, the management board may be authorised in the articles to make an advance payment. However, such authority is subject to several restrictions. First, the payment can only be made after the close of the business year and only if the preliminary annual accounts show a profit for that business year.[106] Secondly, the dividend must not exceed half of the current annual profit and of the balance sheet profit of the previous year.[107] Thirdly, the declaration of the dividend must

---

[100] ibid. The rejection of a monistic view of the corporation with the shareholders at its epicentre is reinforced by the German Constitution, art 14(2), which provides that 'property entails obligations' and that 'its use shall serve the public good'. *Sozialbindung des Eigentums*.
[101] See T. Pötzsch in Assmann, et al (eds), n 90 above, Einl. 27.
[102] Law of 27 April 1998 (Federal Law Gazette I p 786) (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich).
[103] Multiple voting rights are now generally prohibited for the stock corporation in the Stock Corporation Act, s 12(2), and voting caps for public companies in s 134(1).
[104] A naked warrant is a warrant that is issued without an accompanying bond.
[105] Stock Corporation Act, s 174.
[106] ibid, s 59(2).
[107] ibid.

be approved by the supervisory board.[108] Fourthly, the law generally envisages payment of dividends in cash. Dividends in kind are (now)[109] permitted if the articles so provide, but again it is necessary to procure a resolution of the general meeting to authorise this.[110] Thus, as compared to other countries, for example the United States and the United Kingdom, the issuing of warrants as a dividend is cumbersome, and the management board has limited flexibility in terms of timing.[111]

These dividend restrictions notwithstanding, the objective of a poison pill can theoretically be achieved by means of naked warrants or convertible bonds. However, the use of both devices as takeover defences is problematic. In contrast to UK law, the German Stock Corporation Act provides for several comprehensively regulated forms of capital increase that follow (partially) distinct rules. The law envisages as the regular form of capital raising the increase of capital against contributions.[112] This terminology is somewhat misleading because other types of capital increase, namely contingent and authorised capital,[113] also require the subscribers to make contributions. The distinctive feature of a capital increase against contributions is that the capital increase has to be carried out 'without undue delay'.[114] It becomes effective once the requested contribution has been paid up,[115] and the capital increase is registered in the register of companies.[116] Authorised capital, on the other hand, allows the management board greater flexibility in deciding about the timing and conditions of the capital increase. The management board can be granted authorisation in the articles for a period of not more than five years to issue and allot shares and determine whether pre-emptive rights should be excluded.[117] In that case, the amended articles need to be registered in the register of companies,[118] but the capital increase is not effective, and contributions do not need to be paid up, until the management board decides to issue the new shares.[119] Finally, contingent capital can be created by resolution of the general meeting for the purpose of meeting conversion or subscription rights of holders of convertible bonds, preparing for a merger, or

---

[108] ibid, s 59(2), (3).
[109] Amendment of the Stock Corporation Act by Law of 19 July 2002 (Transparenz- und Publizitätsgesetz), Federal Law Gazette I p 2681.
[110] Stock Corporation Act, s 58(5).
[111] For this reason, the practical relevance of ibid, s 59 is insignificant. See C. Windbichler, *Gesellschaftsrecht* (Munich: Beck, 22nd ed, 2009), s 30/21.
[112] Stock Corporation Act, ss 182-191.
[113] The rules on the contingent capital increase are laid down in the Stock Corporation Act, ss 192-201; those on the authorised capital in ibid, ss 202-206. The fourth, and last, form of capital increase is an increase from the company's reserves. ibid, ss 207-220. It is not relevant for our purposes. For an overview in English, see G. Wirth, M. Arnold, R. Morshäuser, and M. Greene, *Corporate Law in Germany* (Munich: Beck, 2nd ed, 2010), 173-189.
[114] Imperial Court (RG), RGZ 144, 138, 141-142.
[115] The requested contribution must be at least one quarter of the par value plus the premium in full. Stock Corporation Act, ss 36(2), 36a.
[116] ibid, ss 188, 189.
[117] ibid, s 203(2).
[118] ibid, s 181.
[119] ibid, ss 203(1), 189.

granting subscription rights to employees and members of the management of the company.[120] This list is exhaustive.[121] Once provided for in the articles, the capital increase is contingent on the actual exercise of the conversion or subscription rights by the holders of the rights.[122]

Accordingly, pursuant to German corporate law contingent capital is required in relation to warrants, but the contingent capital provisions only contemplate the use of naked warrants as a means of performance-based remuneration for employees and managers of the company.[123] Lower courts and commentators addressing the issue have concluded that it is not legally possible for the company to issue naked warrants in other cases.[124] As currently regulated in the Act, stock options for employees and management are not suitable as a defensive measure. Their volume is restricted to 10 per cent of the company's share capital,[125] and the law now provides for a minimum holding period of four years.[126] In any event, their issuance requires a resolution of the general meeting adopted by a qualified majority (majority of not less than 75 per cent of the legal capital present and voting).[127]

In theory some of these restrictions could be circumvented by a carefully structured convertible bond which has attached warrants *issued to the existing shareholders*. The issuance of convertible bonds involves a similar procedure to that of warrants. It must be based on a resolution of the general meeting adopted by a qualified majority.[128] The general meeting can authorise the management board to issue the convertible bonds with attached warrants for a period of not more than five years.[129]After issuance (and usually expiration of a period of time specified in the bond indenture) the warrants can be separated from the bonds and traded independently. The capital underlying the warrants can be provided as contingent capital, which again requires a resolution of the general meeting adopted by a qualified majority.[130] The volume of the contingent capital (and accordingly, therefore, that of the subscription rights) is limited to half of the company's share capital.[131] In theory, therefore it would be possible to place a significant number of

---

[120] ibid, s 192(2).
[121] U Hüffer, *Aktiengesetz* (Munich: Beck, 9th ed, 2010), s 192/8.
[122] Stock Corporation Act, s 200.
[123] ibid, s 192(2) no 3.
[124] For references see A. Fuchs in Kropff and Semler (eds), n 99 above, vol 6, s 192/48; Hüffer, n 121 above, s 221/75.
[125] Stock Corporation Act, s 192(3).
[126] ibid, s 193(2) no 4. For more details on stock options as a defensive measure see H. Krause, 'Die Abwehr feindlicher Übernahmeangebote auf der Grundlage von Ermächtigungsbeschlüssen der Hauptversammlung' (2002) *Betriebs-Berater (BB)* 1053, 1060 (coming to the same conclusion as here, namely that stock options are not effective as a defensive measure).
[127] Stock Corporation Act, s 193(1).
[128] ibid, s 221(1). The articles may reduce the majority requirement from 75 per cent to simple majority.
[129] ibid, s 221(2).
[130] ibid, s 192(2) no 1. Theoretically, s 182 (capital increase against contributions) or s 202 (authorised capital) also constitute possible methods to create the underlying capital, but they are less convenient (see Hüffer, n 121 above, s 221/59). All three methods require a shareholder resolution.
[131] Stock Corporation Act, s 192(3).

warrants in circulation through a nominally priced convertible bond, say one cent per bond, to be purchased by the existing shareholders.[132] However, in order to be convertible into shares the conversion price would also have to be nominal in such a case. While the management board has discretion to determine the terms and conditions of the bond, which would include the triggers to being able to exercise the warrants,[133] the conversion price must be fixed by the general meeting in the resolution that creates the underlying capital.[134] Companies usually either specify a minimum price (floor) or a maximum markdown. This is considered to be in accordance with the requirements of the Stock Corporation Act by most, but not all commentators and courts.[135] Notwithstanding the legality of such a resolution, the low floor would alert shareholders to the intention of the management board to deploy a takeover defence as the nominal bond could not serve any other function. In addition, convertible bonds, even if nominally priced, are of course not simply issued to a passive third party; rather they require an active contracting party.[136] Thus, management must be able to muster sufficient enthusiasm from shareholders to actually subscribe for a large number of bonds. In consequence, nominal convertible bonds with warrants cannot be put in place without both *ex ante* shareholder approval, with shareholders being fully aware of the intention of the management board to use the bond as a poison pill, and the willingness by a significant number of shareholders to actively purchase the bonds and detachable warrants.

An alternative way in which management could put in place a device that resembles a poison pill is to issue an ordinary convertible bond and to include in the bond's terms and conditions a change of control clause that may provide, for example, for an adjustment of the conversion price where a bidder acquires a specified percentage of the target's capital. Theoretically, the management board could also structure the bond in a way that makes it effectively redeemable, for example by retaining discretion as to whether and to what extent to adjust the conversion price. Such convertible bonds (without the redemption option) have in fact been put in place in the recent past. They were ostensibly issued for financing purposes and have neither been tested as a takeover defence in an actual bid nor challenged by dissenting shareholders.[137] A suspicion remains, however, that they were used for defensive purposes.[138] The change of control clauses usually provide for staggered adjustments, for example a reduction of the conversion price by 25

---

[132] We stress the nominal nature of the bond as shareholders are unlikely to authorise the issue of convertible bonds to a third party that contains potentially dilutive warrants, but at the same time shareholders may not wish to use their capital to purchase a non-nominal corporate bond.

[133] Unless the terms have been laid down in the resolution of the general meeting pursuant to the Stock Corporation Act, s 221(1), which is permitted but not required, see O. Seiler in G. Spindler and E. Stilz (eds), *Kommentar zum Aktiengesetz* (Munich: Beck, 2007), vol 2, s 221/59.

[134] Stock Corporation Act, s 193(2) no 3.

[135] See O. Rieckers in Spindler and Stilz (eds), n 133 above, s 193/14 for references.

[136] Creation follows civil law. See Civil Code, s 793.

[137] See J. Freiherr v. Falkenhausen and H. v. Klitzing, 'Wandelanleihen als Poison Pill' (2006) 27 *Zeitschrift für Wirtschaftsrecht (ZIP)* 1513, for examples.

[138] ibid.

per cent if the change of control occurs within one year after issuance, by 19 per cent during the second year, 12 per cent during the third year, six per cent in the fourth year, and no reduction thereafter.[139] This contractual arrangement is functionally identical to a poison pill because the bidder's holding – assuming he did not participate in the convertible bond issue on a pro-rata basis at an earlier date – is diluted significantly if a sufficient number of bondholders exercise their conversion right and the reduction of the conversion price is substantial.

However, the discretion of the management board and the scope of possible reductions of the conversion price are restricted by the requirement that the (reduced) price must continue to be above the minimum which is set in the shareholder resolution authorising the issue of the bonds.[140] Subject to this requirement, shareholders could in theory authorise the directors to issue a convertible bond that could subsequently be subject to a dilutive conversion price set by management (without the shareholders explicitly consenting to any reductions in the conversion price). However, if issued to anyone other than the shareholders themselves, in contrast to a poison pill, the benefits would accrue to the third party creditors and not the shareholders. For that reason it seems highly unlikely that it could be used by managers as a defence unless the managers persuade the shareholders to put the pill in place by buying the bonds themselves. If they were to do so that would amount in effect to explicit *ex-ante* approval for the defence. Furthermore, any attempt to issue such bonds to third parties would be subject to significant restrictions imposed by the regulation of pre-emption rights.

According to the Stock Corporation Act, shareholders have pre-emption rights not only in share issues, but also when convertible bonds are issued.[141] Consequently, shareholders must approve both the issue of the bond and the waiver of the pre-emption rights.[142] The waiver requires a majority of at least 75 per cent of the votes cast, even if the articles provide for a lower majority for the issuance of the bond.[143] In addition, two further pre-emption right restrictions are applicable. First, the intention to exclude the pre-emption rights must be disclosed in the form prescribed in the statute, and management must prepare a report for the general meeting describing the reasons for the exclusion.[144] Second, the resolution is voidable if the issue price is 'inadequately low'.[145] What is inadequate

---

[139] ibid, 1514.
[140] ibid, 1518.
[141] s 221(4).
[142] Shareholders may either wave the pre-emption rights themselves in the resolution approving the bond issue or authorise the management board to do so (analogy to Stock Corporation Act, s 203(2)). See Federal Court of Justice (BGH) AG 2007, 863; Higher Regional Court (OLG) München, AG 1994, 372, 373; OLG München, AG 1991, 210, 211.
[143] Stock Corporation Act, ss 221(4), 186(3).
[144] ibid, ss 221(4), 186(4), 121(4).
[145] ibid, s 255(2). See U. Hüffer in Kropff and Semler (eds), n 99 above, vol 7, s 255/10; M. Schwab in K. Schmidt and M. Lutter (eds), *Aktiengesetz* (Cologne: Otto Schmidt, 2008), vol 2, s 255/9 (discussing and confirming the applicability of the Stock Corporation Act, s 255 in this case).

is not defined in generally applicable quantitative parameters but depends on the circumstances of each case and the interests of the company.[146] The provision is phrased in sufficiently general terms to allow some deviation from the stock market price of the company's shares or the company's 'true' value according to the fundamentals. However, this requirement would prohibit discounts of the magnitude common in US-style poison pills, undermining the potency of this defence.[147] Furthermore, while the management board has some discretion to determine what is in the best interest of the company,[148] the resolution authorising the non pre-emptive convertible bond issue will most likely not withstand judicial scrutiny if the guiding consideration was the entrenchment of the members of the management board.

3.1.2 Equity restructuring

As far as the restructuring defence is concerned, German law is again more restrictive than US or UK law, although the difference is less pronounced with respect to the United Kingdom due to the harmonising influence of European law. As discussed, interim dividends are prohibited, and ordinary dividends require shareholder approval. Share buy-backs must generally be authorised by the shareholders.[149] Authorisation can be given for a maximum of five years by resolution adopted with a simple majority. The resolution can, but does not need to, delineate the purpose of the authorisation.[150] If the shareholders grant unlimited authorisation for a lengthy period of time it is therefore conceivable that the management board will later make use of its powers to defend against a hostile bid that the shareholders did not envisage at the time of authorisation and which is viewed favourably by the shareholders. However, the effectiveness of authorised share buy-backs as a takeover defence is limited because their volume is restricted

---

[146] Federal Court of Justice (BGH), BGHZ 71, 40, 51 (*Kali und Salz*); Higher Regional Court (OLG) Jena, AG 2007, 31, 35. See also W. Bayer, 'Kapitalerhöhung mit Bezugsrechtsausschluss und Vermögensschutz der Aktionäre nach § 255 Abs. 2 AktG' (1999) 163 *Zeitschrift für das Gesamte Handels- und Wirtschaftsrecht (ZHR)* 505, 523-543; Hüffer, n 121 above, s 255/5; T. Johannsen-Roth and S. Goslar, 'Rechtliche Rahmenbedingungen für Übernahmeprämien bei Misch- oder Tauschangeboten im Lichte von § 255 Abs. 2 Satz 1 AktG und § 57 AktG' (2007) *Die Aktiengesellschaft (AG)* 573, 575-579; W. Zöllner in W. Zöllner (ed), *Kölner Kommentar zum Aktiengesetz* (Cologne: Carl Heymanns, 1985), vol 2, s 255/10 (discussing among other things the question whether the importance of the new shareholder for the company and the contribution to be made are relevant for the determination of 'adequacy' within the meaning of the Stock Corporation Act, s 255(2)).

[147] See, eg, Fuchs, n 124 above, s 193/16, who argues that a five per cent discount to the current stock market price is still permissible.

[148] See, eg, Higher Regional Court (OLG) Jena, AG 2007, 31, 35; Johannsen-Roth and Goslar, n 146 above, 578.

[149] Stock Corporation Act, s 71(1) no 8.

[150] Regional Court (LG) Berlin, AG 2000, 328, 329 (*Bankgesellschaft Berlin*). But see also Higher Regional Court (OLG) München, AG 2003, 163-164 (holding that the resolution is voidable if there is no conceivable legally permissible purpose for which the authorisation could be used, for example because the company is indebted to an extent that will prevent it from forming the reserve required for the purchase according to the Stock Corporation Act, s 71(2)). For further discussion of this point and references, see H. Merkt in K.J. Hopt and H. Wiedemann (eds), *Aktiengesetz Großkommentar* (Berlin: De Gruyter, 4th ed, 2008), vol 2, s 71/266.

to 10 per cent of the company's legal capital.[151] It may, of course, be a useful device if combined with other defences, for example the placement of a block of shares with a friendly third party.

The statute allows for limited exceptions for management to effect a buy-back without shareholder approval. The most relevant in this context provides that the company can purchase its own shares where this is 'necessary in order to prevent the company from suffering severe and imminent damage'.[152] It is not clear if or when a hostile takeover can pose a 'severe and imminent' danger. The courts have not yet dealt with the issue. Commentators agree that the provision should be interpreted restrictively.[153] Most notably, a danger must exist for the company, ie, it must be shown that there is an immediate risk to the impairment of the company's assets. The intention of the bidder to squeeze out minority shareholders or lay off parts of the workforce does not give rise to the threat of 'imminent damage' unless there is a clear risk that the restructuring will lead to a substantial financial loss for the company, for example because the bidder seeks to loot the target.[154] A large part of the literature rejects the right of the management board to purchase the company's own shares even in such a case.[155] In any event, the restriction on the volume of share buy-backs mentioned in the previous paragraph also applies to a buy-back to avert imminent danger.[156]

More potent as a defensive measure than share buy-backs are increases of the company's share capital and the placement of a block of shares with a friendly third party. An overview of the different forms of capital increase in the Stock Corporation Act was given above.[157] The method offering the most flexibility to management, and hence the most relevant for our purposes, is authorised capital.[158] Pursuant to the respective provisions, the articles of association can authorise the management board for a period of up to five years to increase the share capital by an amount specified in the authorisation.[159] If the general meeting resolves to grant the authorisation after formation of the company, the resolution to amend the articles must be adopted by a majority of 75 per cent.[160] The volume of the authorised capital is limited to one-half of the company's existing legal capital,[161] but this would clearly be sufficient to defend effectively against a large number of takeovers. Furthermore, the shareholder resolution can authorise the

[151] Stock Corporation Act, s 71(1) no 8.
[152] ibid, s 71(1) no 1.
[153] See Merkt, n 150 above, s 71/159 for references.
[154] See, for example, Hüffer, n 121 above, s 71/9 with references.
[155] See Merkt, n 150 above, s 71/181 for references.
[156] Stock Corporation Act, s 71(2).
[157] See n 112 above and accompanying text.
[158] Stock Corporation Act, ss 202-206.
[159] ibid, s 202(1).
[160] ibid, s 202(2).
[161] ibid, s 202(3).

board to exclude shareholders' pre-emption rights.[162] With the consent of the supervisory board, the management board is empowered to determine the rights attached to the newly issued shares, provided that the resolution of the general meeting does not contain specific instructions in this regard.[163]

Since authorised capital is widely used in practice, and shareholder resolutions typically authorise the exclusion of pre-emption rights, the management board is largely unconstrained by the Stock Corporation Act in issuing shares to a friendly third party to frustrate a takeover bid. Of course, shareholders concerned about managers abusing such authorisation in a hostile context could impose conditions on the authorisation.[164] Save such a limitation, the only substantive constraint imposed on the board's discretion by the Act is the requirement that the issue price of the new shares should not be 'inadequately low' if pre-emption rights are entirely or partially excluded.[165] However, what the Stock Corporation Act says, or does not say, is not the end of this story.

3.1.3 Additional requirements for the exclusion of pre-emption rights

In addition to the express requirements for the exclusion of pre-emption rights laid down in the Stock Corporation Act, the courts have developed unwritten substantive requirements to which a resolution of the general meeting and (in the case of authorised capital) the subsequent decision of the management board to make a non-pre-emptive issue must conform. These requirements apply both to the exclusion of pre-emption rights in the context of a share issue and an issue of convertible bonds.[166] They stem from a famous line of cases decided by the Federal Court of Justice over the course of 20 years towards the end of the last century.[167] The relevant criteria have changed over time, but the doctrine is now well developed and can readily be summarised. In the first of these cases, *Kali und Salz*, which did not deal with authorised capital but a regular capital increase against contributions approved by resolution of the general meeting,[168] the Court

---

[162] ibid, s 203(2). The exclusion requires the consent of the supervisory board. Additional formal requirements are contained in ibid, ss 203(2), 186(4).

[163] ibid, s 204(1).

[164] F. Wamser in Spindler and Stilz (eds), n 133 above, s 202/83.

[165] Stock Corporation Act, s 255(2). For the applicability of s 255(2) when the general meeting authorises management to increase the share capital and allot shares pursuant to ibid, s 202, but the authorisation does not specify the minimum issue price, see Federal Court of Justice (BGH), BGHZ 136, 133, 141 (*Siemens/Nold*); Higher Regional Court (OLG) Karlsruhe, AG 2003, 444, 447; Higher Regional Court (KG) Berlin, ZIP 2007, 1660, 1662; Hüffer, n 145 above, s 255/13; E. Stilz in Spindler and Stilz (eds), n 133 above, s 255/6-11. For the requirement that shares be issued at 'the best possible' or at least an 'adequate' price where the capital increase is effected pursuant to the Stock Corporation Act, s 182, under exclusion of pre-emption rights and the general meeting has not specified the issue price, see Hüffer, n 145 above, s 255/12; H. Wiedemann in Hopt and Wiedemann (eds), n 150 above, vol 6, s 182/68; Zöllner, n 146 above, s 255/12.

[166] Higher Regional Court (OLG) München, AG 1994, 372, 374; OLG Frankfurt a.M., AG 1992, 271; OLG München, AG 1991, 210, 211.

[167] BGHZ 71, 40 (*Kali und Salz*); 83, 319 (*Holzmann*); 136, 133 (*Siemens/Nold*). For an application of the principles in the more recent case law, see in particular BGHZ 164, 241 (*Mangusta/Commerzbank I*); BGHZ 164, 249 (*Mangusta/Commerzbank II*).

[168] Stock Corporation Act, s 182.

held that the exclusion of pre-emption rights was only valid if it was justified by objective requirements in the interest of the company. The test required the management board to balance the conflicting interests of shareholders and the company and determine that the exclusion was proportionate, that is, suitable and necessary in light of the board's objectives in issuing the shares.[169]

This test was applied by the Court to a capital increase in the form of authorised capital and an authorisation to exclude shareholders' pre-emption rights a few years later in *Holzmann*. The Court adopted a strict stance and emphasised that the *Kali und Salz* standard operated at two levels in the case of authorised capital. First, the management board was under an obligation to examine whether the exclusion of pre-emption rights was an 'adequate and the most suitable means to pursue preponderant interests of the company' at the time when it wanted to make use of the authorisation.[170] Second, at the time of adoption of the resolution the management board had to provide the general meeting with specific facts pointing to the possibility that it will in the future become necessary to allot shares non-pre-emptively.[171] If no such development could be foreseen the authorisation would be voidable.[172] In particular, it was not sufficient to adopt a boilerplate resolution, for example one that authorised management to exclude pre-emption rights whenever this was necessary 'to prevent the company from suffering damage'.[173]

In *Siemens/Nold*, a case that was first referred to the ECJ,[174] the German Federal Court of Justice acknowledged that the *Holzmann* requirements were not practicable in the case of authorised capital. In order to give the management board flexibility to react quickly to new developments in the capital markets and safeguard the legitimate interests of the company not to disclose confidential information, it allowed the board to describe the purpose of the capital increase and the parameters of the authorisation in abstract terms.[175] The court observed further that at the time of allotment of the shares and exclusion of the pre-

---

[169] BGHZ 71, 40, 46. The Court developed this doctrine from older case law that had allowed the management board to exclude pre-emption rights and allot shares to particular shareholders to defend against a hostile takeover where the bidder had the intention to break up the company. See BGHZ 33, 175 (*Minimax II*). Thus, the creation of voting majorities as a takeover defence is not per se impermissible; however, the crucial question is whether the management board can use authorised capital to make its own assessment of whether the takeover constitutes a threat to the company or whether that authority lies ultimately with the general meeting. It is submitted that the latter is the case, as the discussion in the next paragraphs will show.

[170] BGHZ 83, 319, 321.

[171] ibid, 322.

[172] If the general meeting excludes the pre-emption rights in the resolution authorising management to allot shares, which is permissible pursuant to the Stock Corporation Act, ss 203(1), 186(4), the Court held that the facts provided by the management had to be sufficiently specific so as to enable the general meeting to balance the interests of shareholders and the company and assess the proportionality of means (exclusion of pre-emption rights) and purpose conclusively already at the time of the adoption of the resolution. BGH AG 1995, 227, 228 (*Siemens AG*).

[173] BGHZ 83, 319, 327.

[174] Case C-42/95 *Siemens AG* v *Henry Nold* [1996] ECR I-6017.

[175] BGHZ 136, 133, 136-140.

emption rights the management board had to assess carefully whether the specific circumstances that had prompted the board to make use of the authorisation were in conformity with the abstract parameters laid down in the resolution, and whether the share allotment was in the best interest of the company.[176] Thus, the strict *Holzmann* standard was modified by the Court.

However, this does not mean that the management board has unfettered discretion to use the authorisation as it considers appropriate. The courts continue to require that the board disclose the transaction or type of transaction it intends to pursue or business policy it wishes to implement by means of the capital increase.[177] The disclosure must be sufficiently precise to set limits to the board's discretion against which the legality of the share allotment and exclusion of pre-emption rights can be measured.[178] Accordingly, a statement holding that the capital increase was necessary 'in order to enable the company in the course of a new business strategy to acquire shareholdings and/or trademarks and/or licences and/or other assets [...] and to allow partners of strategic importance to acquire holdings in the company [...]' without specifying what the new business strategy consisted of, was too broad to pass the (modified) test of the Federal Court of Justice.[179]

The legislature reacted to the restrictive approach of the *Kali und Salz* and *Holzmann* decisions by inserting a safe harbour into the Stock Corporation Act.[180] The requirement to balance the interests of shareholders and the company, or to show any grounds for justification of the exclusion of preemption rights, does, generally,[181] not apply if four conditions are met: (1) The shares are issued for contributions in cash, not in kind; (2) the capital increase does not exceed 10 per cent of the company's share capital; (3) a stock market price exists for the shares;[182] and (4) the issue price is not significantly below that stock market price. However, it should be noted that only the requirements of *Kali und Salz* and its progeny (so-called *materielle Beschlusskontrolle*) are inapplicable. Other obligations stemming from fiduciary duties or the equal treatment principle continue to constrain the discretion of the directors.[183] In addition, the restriction to capital increases not exceeding 10 per cent of the share capital limits the effectiveness of the provision as a takeover defence.

---

[176] ibid, 139.

[177] In *Siemens/Nold*, the capital increase was intended to enable the company 'to acquire shareholdings in particular, suitable cases'. The Court accepted this statement as sufficient justification for the authorisation. ibid, 134-135.

[178] Higher Regional Court (OLG) München, AG 2003, 451, 452 (*MHM Mode Holding AG*).

[179] ibid.

[180] Law of 2 August 1994 (Federal Law Gazette I p 1961) (Gesetz für kleine Aktiengesellschaften und zur Deregulierung des Aktienrechts), art 1, amending the Stock Corporation Act, s 186(3), and inserting sentence 4. For the reasons of the amendment see the explanatory memorandum of the draft law, Bundestags-Drucksache 12/6721, 10 (emphasising the need to facilitate capital-raising and avoid disadvantages for German companies compared to companies governed by legal systems that provide for more flexibility).

[181] For exceptions, see Hüffer, n 121 above, s 186/39g with references.

[182] However, the provision does not require that the shares trade on a regulated market.

[183] See W. Servatius in Spindler and Stilz (eds), n 133 above, s 186/61 and the discussion at s 3.2 below.

For our purposes, the following conclusions can be drawn. If the management board has been authorised to issue shares (exceeding 10 per cent of the company's share capital) and exclude pre-emption rights, for example, to finance acquisitions, it is not at a later point entitled to allot the shares to a friendly third party in order to frustrate a hostile bid. Furthermore, if the board expects the company to become the target of a takeover offer and contemplates using additional equity to defend against the bid, it must disclose this objective to the general meeting. There are good reasons to assume that an authorisation that does not go beyond general phrases such as a reference to 'the interests of the company', or the declared intention to be able to react to 'new developments in the market' will fail the Court's test. Thus, even though the law does not provide for *ex-post* shareholder approval of share issues if the general meeting has created authorised capital and waived pre-emption rights, the courts have created duties that effectively ensure that the shareholders retain a modicum of control after they have granted authorisation.[184] It should also be noted that these requirements

[184] This also seems to be the opinion of the practice in Germany, as illustrated by the recent takeover battle between Hochtief AG and the Spanish construction group ACS. ACS acquired a holding of about 25 per cent in Hochtief in March 2007, initially denying any intention to take over the German group. In the following months ACS increased its shareholding to just below 30 per cent, the threshold for a mandatory offer under the Securities Acquisition and Takeover Act 2001, s 30, and announced its plan to make a takeover offer. It intended to acquire control (defined as 'the holding of at least 30 per cent of the voting rights in the target company' (ibid, s 29(2)) through a voluntary bid in order to evade the requirement to make a mandatory bid (ibid, s 30(3)). Hochtief qualified the bid as hostile. In December 2010, a few days after ACS had published its offer, the management board of Hochtief made use of the authorised capital that had been created at the annual general meeting earlier in the year and increased the company's capital by 10 per cent under exclusion of pre-emption rights. Qatar Holding subscribed to all new shares for contributions in cash. See Hochtief press release of 6 December 2010 at <http://www.hochtief.com/hochtief_en/201.jhtml?pid=8665>. The shares were ostensibly issued to Qatar Holding to develop a 'strategic partnership', but they had the effect of diluting the holding of ACS from just below 30 per cent to ca 27 per cent and potentially requiring ACS to submit a second, mandatory bid if they failed to acquire control with the first, voluntary offer. The share issue was, therefore, evidently designed to make the bid more costly and function as a takeover defence. It is instructive to consider the authorisation in the company's articles creating the authorised capital. The authorisation distinguished between a capital increase against cash contributions not exceeding 10 per cent of the legal capital and an increase against non-cash contributions exceeding 10 per cent. The resolution of the general meeting authorised the management board 'to exclude shareholders' subscription rights up to an amount when using this authorization [to increase the share capital] once or several times that is not more than 10 per cent of the share capital on the date this authorization becomes effective and – if this value is lower – the share capital which exists on the date this authorization is exercised, in order to issue the new shares against cash contributions at an issuing price which is not significantly lower than the stock market price of the shares of the company which are already listed on the date the issuing amount is finally determined'. See Hochtief Notice of General Shareholders' Meeting of May 11, 2010, 17. The notice is available from the website of Hochtief AG at <http://www.hochtief.com/hochtief_en/730.jhtml> (follow hyperlinks 'General Shareholders' Meeting 2010' and 'Invitation to the General Shareholders' Meeting'). In respect of capital increases not conforming to these conditions the resolution required that the capital increase 'is used to acquire companies, parts of companies or equity participations in companies or other assets'. ibid. The management board explained that the exclusion of pre-emption rights in such cases 'allows the company to react quickly and flexibly to opportunities that may present themselves […]. The authorization applied for will thus, in a given situation, allow optimum financing of the acquisition against the issue of new shares while strengthening the company's equity base. […] In any case, the company's management will only use the opportunity of a capital increase against non-cash contributions using the authorization to

restricting the board's autonomy are, due to their binding nature, probably even more effective in preventing abuse of pre-emption right waivers than the self-regulatory initiatives of the Pre-Emption Group in the United Kingdom.

3.1.4 Asset sales/crown jewels defence

Asset sales fall within the competence of the management board, with the exception of a transfer of the entire undertaking of the company.[185] Therefore, the sale of the company's crown jewels constitutes a takeover defence that can, in principal, be adopted by management without involvement of the general meeting – subject to the constraints on the discretion of management that will be discussed below. If the company enters into a contract to transfer its entire undertaking without effecting a merger or other form of business combination pursuant to applicable statutory procedures, which all provide for shareholder involvement,[186] the Stock Corporation Act requires approval of the contract by a resolution of the general meeting with at least a 75 per cent majority.[187] The courts do not interpret the provision literally. The requirement to procure shareholder approval is triggered even where particular assets remain with the company, provided that they are of no more than 'subordinate, ancillary importance'.[188] The relevant test is not exclusively quantitative, involving a comparison between the value of the assets that remain and those that are transferred. Rather, the courts ask whether the company continues to be able to pursue its statutory objects, at least to a limited extent, with the remaining assets.[189] Nevertheless, the threshold is high and a sale of crown jewels that does not result in a change in the company's objects can be carried out by management alone.[190]

---

exclude subscription rights from authorized capital if the value of the new shares is reasonably in proportion to the value of the compensation for the company, part of a company, the equity interest or other asset to be acquired. […] When weighing up all of these circumstances, the authorization to exclude subscription rights to the extent described is required, suitable, reasonable and called for in the company's interest'. ibid, 18-19. The resolution illustrates how the doctrine established in *Kali und Salz* and refined in *Siemens/Nold* constrains the management board's discretion to use authorised capital for defensive purposes. The authorisation with regard to capital increases not exceeding 10 per cent of Hochtief's share capital was, of course, drafted in a way to enable the management board to take advantage of the safe harbour in the Stock Corporation Act, s 186(3) sentence 4. Hochtief used only this part of the authorised capital to defend against ACS. Apparently, it was felt that with respect to capital increases beyond the scope of s 186(3) sentence 4 defensive measures were not covered by the description of the purpose of a capital increase as stipulated in the resolution and that the proportionality requirement developed in the case law and reproduced in the resolution left the capital increase vulnerable to legal challenges. This limited room for manoeuvre of the board of Hochtief was not sufficient to defend against ACS's bid. In spite of the diluting effect of the 10 per cent share issue, ACS succeeded in acquiring control through its voluntary offer and is now free to increase its shareholding in due course without the need to make another bid. For a timeline of the events in the Hochtief/ACS case, see 'ACS nimmt Hürde von 30 Prozent' (4 January 2011). *Frankfurter Allgemeine Zeitung.*

185 Stock Corporation Act, s 179a.

186 See in particular Transformation Act, Law of 28 October 1994 (Federal Law Gazette I p 3210).

187 s 179a(1).

188 Imperial Court (RG), RGZ 124, 279, 294 (rejecting an application of what is now the Stock Corporation Act, s 179a, even though the asset sale led to a substantial restructuring of the company because outstanding claims that amounted to several million RM were excluded from the transfer).

189 Federal Court of Justice (BGH), BGHZ 83, 122 (*Holzmüller*).

190 Assuming that directors' duties do not require otherwise. See further text to nn 201-233 below.

3.2 General corporate legal restraints on the use of board controlled defences

3.2.1 The pre-Takeover Act 2001 position

We consider here general principled restrictions on the use of takeover defences in German law. The adoption of the 2001 Takeover Act, and its explicit approval of the use of takeover defences in certain circumstances, renders the application of these general principles partially moot today. However, for our purposes these restrictions remain important for two reasons. First, these general principles continue to be of relevance for pre-bid-defences[191] and offers that do not fall within the scope of the Takeover Act.[192] Secondly, the 2001 Act is in large part the product of the Takeover Directive process initiated by the Commission. To the extent that the 2001 Act overrules pre-existing German law that would have constrained the use of takeover defences it raises the interesting question of whether the Directive process itself undermined its own objectives by altering a pre-Directive neutrality bias in German corporate law – a process that the Commission may have thought twice about had they paid attention to Member State corporate law.

3.2.2 General duty of neutrality

The question whether the management board is subject to a general duty not to adopt measures that may frustrate a takeover bid was hotly debated before adoption of the Securities Acquisition and Takeover Act of 2001. Both the legal foundation of the duty and its extent are controversial. Court decisions that could provide guidance are rare,[193] reflecting the dormant nature of the market for corporate control in Germany for most of the last century. Commentators

---

[191] The (qualified) BNR pursuant to the Takeover Act, s 33, applies from 'publication of the decision to make an offer [...] until publication of the result'. s 33(1). Before publication, the management board is subject to the general corporate legal restraints in adopting preventive measures. See Krause and Pötzsch, n 90 above, s 33/71, 243-245. However, the literature suggests that these restraints (for example the general duty of neutrality – see below in the main text) have to be modified now, after adoption of the 2001 Takeover Act, in order to avoid inconsistencies with the 2001 Act, s 33. It is argued that pre-bid defences should not be subject to more stringent requirements (as was the case under the general corporate law BNR before adoption of the 2001 Act) than defences that fall within the scope of the Takeover Act, s 33. See H. Krause and T. Pötzsch, ibid, s33/71, 245; A. Schwennicke in S. Geibel and R. Süßmann (eds), *Wertpapiererwerbs- und Übernahmegesetz* (Munich: CH Beck, 2nd ed, 2008), s 33/61; L. Röh and H.G. Vogel in Haarmann and Schüppen (eds), n 89 above, Vor ss 33ff/68-69; R. Steinmeyer in R. Steinmeyer and M. Häger (eds), *Wertpapiererwerbs- und Übernahmegesetz* (Berlin: Erich Schmidt, 2nd ed, 2007), s 33/7.

[192] Securities Acquisition and Takeover Act, s 1. Importantly, the Takeover Act only applies to securities of target companies (German stock corporations or partnerships limited by shares or companies domiciled in another Member State of the European Economic Area) that are admitted to trading on an 'organised' market (equivalent to the regulated market under MiFID). See ibid, ss 1(1), 2(3), (7).

[193] See, eg, Federal Court of Justice (BGH), BGHZ 70, 117 (*Mannesmann*) (holding that the introduction of a five per cent voting cap as a defensive measure by resolution of the general meeting was legitimate); Regional Court (LG) Düsseldorf, WM 2000, 528 (discussing the permissibility of the target's board to conduct an advertising campaign advocating a rejection of the offer).

generally rely either on the provisions of the Stock Corporation Act that define the powers and competences of the management board,[194] or the equal treatment principle,[195] to argue that the board is not entitled to influence the ownership structure of the company.[196] Some endorse a far-reaching duty of neutrality, holding that the board is prohibited from adopting any measure that frustrates the bid with the exception of: statements by the board that inform the shareholders about the advantages or disadvantages of the offer; the search for a competing offer; and the use of defences where the offer is likely to cause substantial damage to the company, for example by damaging its market position.[197] Others identify a weaker restraint on defensive action involving a requirement that the defensive action is in the interest of the target and its shareholders.[198] A minority denies the existence of a strict duty of neutrality and accords the management board greater freedom in deploying potentially frustrating devices.[199] However, this view also acknowledges that the management board does not have unfettered discretion to react to a takeover offer as it sees fit, but that it must act in the interest of the company, the shareholders, and potentially other stakeholders (such as the employees), and not in order to entrench itself.[200]

Notwithstanding the fact that the existence and parameters of a general duty of neutrality remain uncertain, it is uncontroversial that directors' duties require the board in *some* situations to refrain from adopting measures that tamper with the right of shareholders to determine the structure of the company and to decide on fundamental changes. While the courts have not addressed the question of an all-encompassing duty of neutrality, they have dealt with more specific issues of interference with membership rights by the management board. This body of case law is informed by duties that safeguard the supremacy of the general meeting in particular transactions. It can, accordingly, be understood as shaping the duty of neutrality for the instances that it deals with. It lends weight to the thesis that the requirement of board neutrality is an undercurrent of large parts of general German corporate law. The next sections will give an overview of the most relevant cases and discuss their implications for takeover defences.

---

194 Most importantly the Stock Corporation Act, s 76(1), which provides that the management board shall manage the company under its own responsibility. This view is informed by the *Holzmüller* case law of the Federal Court of Justice, which will be discussed in the next section.

195 See s 3.2.2 below.

196 See, eg, Hefermehl and Spindler, n 99 above, s 76/28-29; K.J. Hopt, 'Aktionärskreis und Vorstandsneutralität' (1993) 22 *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 534, 545-566; G. Krieger, 'Aktionärsklage zur Kontrolle des Vorstands- und Aufsichtsratshandelns' (1999) 163 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR)* 343, 357-358; H.J. Mertens and A. Cahn in W. Zöllner and U. Noack (eds), *Kölner Kommentar zum Aktiengesetz* (Cologne: Carl Heymanns, 3rd ed, 2010), vol 2/1, s 76/25-27; L. Michalski, 'Abwehrmechanismen gegen Unfreundliche Übernahmeangebote ('unfriendly takeovers') nach Deutschem Aktienrecht' (1997) 42 *Die Aktiengesellschaft (AG)* 152, 159.

197 See, eg, Hefermehl and Spindler, n 99 above, s 76/28-29.

198 See, eg, Mertens and Cahn, n 196 above, s 76/26.

199 Hüffer, n 121 above, s 76/15d; M. Kort in Hopt and Wiedemann (eds), n 150 above, vol 3, s 76/102-103.

200 Kort, ibid.

3.2.3 Holzmüller and its progeny

The Stock Corporation Act restricts the broad powers of management in cases that affect the rights of shareholders in a fundamental way or that are important to ensure the effective control of management, most notably: fundamental changes; increase and reduction of capital; appointment of the company's auditors; and the declaration of dividends.[201] In these cases, corporate action requires a resolution by the general meeting. Outside of these specific approval rights, the general meeting does not, however, have the right to instruct management to take or refrain from taking a specific action. According to the Act, it can decide on matters concerning the management of the company only if requested to do so by the management board.[202]

The statutory allocation of competences was modified by a famous decision of the Federal Court of Justice from 1982, which has given rise to the Court's so-called *Holzmüller* doctrine.[203] According to the doctrine, the management board is under a duty to lay a matter before the general meeting if the board's actions have the consequence of interfering 'so substantially with the rights of the members and their financial interests that the board cannot reasonably assume that it may take a decision in its own right and without participation of the general meeting'.[204] Directors that do not procure a resolution of the general meeting in spite of being required to do so pursuant to the *Holzmüller* doctrine violate their duties under section 93(1) Stock Corporation Act.[205] Claims for damages can be pursued by the company or the shareholders in the form of a derivative action.[206] Furthermore, shareholders can bring a claim for violation of their membership rights against the company (not the directors individually), which is directed at a declaration that the action of the board is null and void or, if possible, restoration of the position prior to the breach of duty.[207]

The courts have not had much opportunity to consider the application of the *Holzmüller* doctrine to takeover defences. The Regional Court of Düsseldorf that dealt with the *Mannesmann* takeover,[208] held that defensive measures taken by the

---

[201] Stock Corporation Act, s 119(1).

[202] ibid, s 119(2). The board may decide to procure a shareholder decision in order to limit its exposure to liability pursuant to the Stock Corporation Act, s 93(4) sentence 1.

[203] Federal Court of Justice (BGH), BGHZ 83, 122.

[204] In *Holzmüller*, the Court of Justice applied the Stock Corporation Act, s 119(2), and argued that the management board's discretion to lay a matter before the general meeting was transformed into a duty under appropriate circumstances. In subsequent decisions the Court altered its interpretation of the dogmatic foundations of the doctrine. It moved away from an outright application of s 119(2) and now combines the consequences that that provision entails (namely, that the transfer of decision-making competences to the general meeting does not exert any legal effects towards third parties) with the requirement that the case under consideration must be analogous to one of the express cases of shareholder decision-making that are contained in the Stock Corporation Act. See Federal Court of Justice (BGH), BGHZ 159, 30, 42-43 (*Gelatine I*).

[205] Federal Court of Justice, n 203 above, 131.

[206] Stock Corporation Act, s 148.

[207] Federal Court of Justice, n 203 above, 125-127, 133-136.

[208] See n 193 above.

management board may be, in principle, subject to the requirements established in *Holzmüller*. However, the fact that the company is the target of a takeover does not entail an all-encompassing transfer of competences to the general meeting for any actions which can prevent the success of the offer.[209] Rather, the Court argued that it has to be decided on a case-by-case basis whether the measure interferes with shareholder rights in a fundamental way and is, therefore, comparable to the situation decided in *Holzmüller*.[210] Interference with shareholder rights is not of the required level of intensity if the management board actively campaigns against accepting the offer, for example, by means of newspaper advertisements, internet announcements, or road shows. It may fall within the scope of *Holzmüller* if the board decides to sell important assets or enter into contracts outside the normal course of business.[211]

After *Holzmüller* there was much speculation in the lower courts and the literature about the threshold necessary to trigger a shift in competences.[212] Some clarification was provided by the Federal Court of Justice in two recent decisions (*Gelatine I and II*).[213] The Court held that the acts of the management board required shareholder approval if they touched upon the 'core competence' of the general meeting to determine the constitution of the company and were in their consequences very similar to those that necessitated an alteration of the articles.[214] The two judgments show that the Court is restrictive in its interpretation of the *Holzmüller* doctrine and considers the allocation of power in the Stock Corporation Act as authoritative save in exceptional cases. After *Gelatine*, it is questionable whether asset sales without any further interference with shareholder rights continue to be subject to the requirement of shareholder approval.[215] In addition, the quantitative threshold for an application of the doctrine is higher than was previously assumed by the courts.[216] It is now generally accepted that the assets in

---

[209] Regional Court Düsseldorf, n 193 above, 529-530.
[210] ibid, 530.
[211] ibid, 530-531.
[212] For an overview, see T. Raiser and R. Veil, *Recht der Kapitalgesellschaften* (Munich: Franz Vahlen, 5th ed, 2010), s 16/13.
[213] Federal Court of Justice, n 204 above, and ZIP 2004, 1001 (*Gelatine II*).
[214] n 204 above, 44.
[215] See, on the one hand, BGH AG 2007, 203; Higher Regional Court (OLG) Hamm, AG 2008, 421-422 (deciding in the negative); on the other hand, OLG Schleswig, AG 2006, 120, 123 (deciding in the positive). The restrictive interpretation is based on the fact that both in *Holzmüller* and *Gelatine* assets were not simply sold to a third party, but removed from the direct reach of the shareholders through reorganisations or the spinning-off of the assets, ie their transfer to a subsidiary. The Court in *Gelatine* acknowledged that it was this 'intermediating effect' that gave rise to the interference with shareholder rights. n 204 above, 41. For a discussion of this point see, eg, M. Habersack, 'Mitwirkungsrechte der Aktionäre nach Macrotron und Gelatine' (2005) 50 *Die Aktiengesellschaft (AG)* 137, 144-148; T. Liebscher, 'Ungeschriebene Hauptversammlungszuständigkeiten im Lichte von Holzmüller, Macrotron und Gelatine' (2005) 34 *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 1, 24; Raiser and Veil, n 212 above, s 16/13.
[216] See, eg, Regional Court (LG) Frankfurt, ZIP 1997, 1698, and Higher Regional Court (OLG) Frankfurt, ZIP 1999, 842 (*Altana/Milupa*) (requiring a decision of the general meeting for a sale of a subsidiary that generated 30 per cent of the group's revenue).

question must amount to 75 to 80 per cent of total assets or revenue in order to trigger the *Holzmüller* obligations.[217]

In light of the clarifications, the decision of the Regional Court Düsseldorf discussed above, which was delivered before *Gelatine*, has to be applied carefully. However, it does not follow that the *Holzmüller* doctrine has lost its relevance for defensive measures unless the 75-80 per cent threshold has been reached.[218] There are good reasons why under both *Holzmüller* and *Gelatine* the management board does not have unfettered discretion to use asset sales as a takeover defence. First, the cases decided by the Federal Court of Justice did not involve takeover bids. Thus, the fact that asset sales that are effected in the normal course of business may no longer be susceptible to violating the *Holzmüller* principles,[219] does not mean that the same holds if they are used to frustrate a hostile bid.[220] Second, *Holzmüller* and *Gelatine* are not only about quantitative thresholds. Rather, the test developed by the Court is a bifurcated one, comprising both quantitative and qualitative criteria. This can be seen most clearly in *Gelatine*, where the Court distinguishes between the character of the transaction as a 'structural measure' (*Strukturmaßnahme*) or a transaction comparable to such a measure, and the level of intensity of interference with the protected position of the shareholders (*Wesentlichkeitsschwelle*).[221] Both parts of the test are preconditions for the unwritten competence of the general meeting.[222] In relation to the first part, relevant factors are: the close resemblance of the case in issue to any of the express cases of shareholder decision-making in the Stock Corporation Act or similar acts[223] (and not only the rules on a transfer of the entire undertaking of the company);[224] an alteration of the structure of the company;[225] an impairment of the shareholders'

---

[217] H. Fleischer, 'Ungeschriebene Hauptversammlungszuständigkeiten im Aktienrecht: Von "Holzmüller" zu "Gelatine"' (2004) *Neue Juristische Wochenschrift (NJW)* 2335, 2337; Liebscher, n 215 above, 15.

[218] But see Davies, et al, n 10 above, 12 (arguing that the *Holzmüller* doctrine requires that the disposals reach 80 per cent of total assets); Raiser and Veil, n 212 above, s 44/42 (rejecting an application of the *Holzmüller* doctrine to asset sales as a defensive measure altogether because of the lack of 'intermediation' of shareholder rights); J. Reichert, 'Mitwirkungsrechte und Rechtsschutz der Aktionäre nach Macrotron und Gelatine' (2005) 50 *Die Aktiengesellschaft (AG)* 150, 157 (pointing out that the initiation of or participation in a takeover by the target's board does not trigger *Holzmüller* because the successful takeover only changes the composition of the shareholder body, and this change depends on the decision of each shareholder to accept or reject the offer).

[219] See n 215 above.

[220] The Federal Court of Justice in *Gelatine* acknowledged that reorganisations were only one of several possible cases of unwritten shareholder competence. It stressed the importance of an 'intermediating effect' in the context of that particular case, ie reorganisations. See n 204 above, 41.

[221] n 204 above, 47-48.

[222] In *Gelatine*, the plaintiffs won on the first count but lost on the second.

[223] The Transformation Act, n 186 above, which regulates mergers, divisions, change of legal form, and other, similar transactions, should deserve the same consideration as the Stock Corporation Act in this context. See Federal Court of Justice, n 204 above, 45-46.

[224] Federal Court of Justice, n 203 above, 131; n 204 above, 37-38, 41, 44-45. The two decisions of the Federal Court of Justice that have so far accepted an unwritten competence of the general meeting dealt with divestments and reorganisations (transfer of a direct holding to a second-tier subsidiary).

[225] Federal Court of Justice, n 204 above, 36.

financial interests;[226] or an interference with other membership rights.[227] The second (quantitative) part is satisfied if the alteration of the structure of the company or interference with shareholder rights is 'fundamental'[228] or 'severe'.[229] The two parts of the test are interrelated. What is 'fundamental' or 'severe' is transaction-specific and cannot be answered in generic terms, for example by specifying a generally applicable, numerical threshold.[230]

As regards the first part of the test, takeovers resemble other fundamental changes in that a successful takeover leads to new ownership of the company, which, in turn, often entails a replacement of management, recalibration of the business strategy, and reorganisation of the undertaking. It constitutes a 'structural measure' that has manifest ramifications for the rights and position of the existing shareholders, both those that decide to stay as minority shareholders in the company and those that would like to sell out. As far as the second part of the test is concerned, it is suggested that it is more meaningful to focus on the effectiveness of the defensive measure, rather than the value of the assets that management intends to transfer. In other words, the question should be whether the defensive tactic will most likely be successful and as a result shareholders will be denied the opportunity to accept the offer and decide about the future of the undertaking. The asset sale will interfere in a 'fundamental' or 'severe' way with shareholder rights if it is likely to frustrate the takeover, notwithstanding the value of the assets. This interpretation is in line with the spirit and purpose of the *Holzmüller* line of cases, which seek to protect shareholders against disenfranchisement.[231] A more significant interference than the denial of the right to decide on a fundamental change is hardly imaginable. That the law takes the protection of shareholders against disenfranchisement in connection with fundamental changes seriously is also shown by the fact that the validity of other fundamental changes (mergers, divisions, change of legal form, voluntary winding-up, profit transfer, or control agreements) depends on shareholder approval by a 75 per cent majority and, furthermore, that these requirements are mandatory, and the articles cannot provide otherwise, for example for a lower majority.[232]

---

[226] ibid, 40.
[227] ibid, 41.
[228] Ibid, 36.
[229] ibid, 41.
[230] Consequently, the figure of 75-80 per cent is used by courts and commentators only in relation to asset sales in the context of reorganisations.
[231] It is also in accordance with the majority view before adoption of the Securities Acquisitions and Takeover Act. See n 196 above.
[232] Mergers: Transformation Act, s 65(1); divisions: ibid, s 125; change of legal form: ibid, s 240(1); voluntary winding-up: Stock Corporation Act, s 262(1) no 2; profit transfer and control agreements: ibid, s 293. Of course, the codification of the position of shareholders in takeovers in the Securities Acquisitions and Takeover Act of 2001 has made clear that the legislature did not wish to convey the same decision-making power on shareholders in the context of takeovers as it did with respect to mergers and other fundamental changes. This may be as it is, but we are proceeding here on the basis of the assumption that an explicit regulation of board and shareholder competences in takeovers does not exist. The law as it stood in 2001 before the Securities Acquisitions and Takeover Act was adopted lends weight to the suggestion that shareholders have the final say on the success or failure of takeovers but for an explicit provision to the contrary.

How the courts would assess this situation is, of course, speculation, given that the *Holzmüller* doctrine has only been fleshed out in a rudimentary way with regard to takeovers. But these considerations may at least have shown that the issue is not as clear-cut as sometimes presented in the literature and that the level of shareholder protection in takeovers in Germany prior to 2001, when Germany had neither an express board neutrality rule nor its 2001 Takeover Act, antithesis was far from nonexistent.[233]

3.2.4 Continuing uncertainty about the status of Holzmüller

It is commonly acknowledged that the general duty of neutrality is no longer applicable after the adoption of the Takeover Act 2001.[234] However, the implications of the Act for the status of *Holzmüller* are more problematic. In order to appreciate the relationship between the Takeover Act and *Holzmüller*, it is necessary to assess how the two measures affect and delineate the position and competences of the board and the shareholders. Section 33 of the Takeover Act, which establishes the modified board neutrality rule, is generally interpreted as being duty-related. The directors violate their duties if they adopt defensive measures that are not in conformity with the provision.[235] This interpretation is convincing. Initially, the draft Takeover Act stipulated that acts of the management board and the supervisory board that might result in the takeover offer being frustrated had to be authorised by the shareholders in general meeting.[236] Thus, similar to the measures that fall within the competences of the general meeting pursuant to the Stock Corporation Act, the draft Takeover Act provided for a shift in competences from the management board to the general meeting. This was altered in Parliament. The Act as adopted removed the supervisory board from the scope of the board neutrality rule and imposed the *obligation* on the management board 'not [to] take any actions which could prevent the success of the offer',[237] rather than restricting the board's powers to do so without shareholder authorisation. Parliament explained that the change was intended to enable the board to deploy defensive measures within their competences if the supervisory board consented to the measure.[238]

---

[233] For this reason (and in light of the points made in the preceding sections, see particularly text to nn 166-184 above), it does not seem to be justified to accord Germany a BNR score of zero before implementation of the Takeover Directive, as Davies, et al, n 10 above, 36, have done. It is appreciated that this score reflects the fact that an *express* BNR did not exist before transposition of the Directive (and still does not exist in Germany, as is indicated by the same score post-implementation. ibid, 31), but it is precisely our point that the non-existence of the rule cannot be relied on alone to determine the extent of the board's defensive power.

[234] See for example Krause and Pötzsch, n 90 above, s 33/50; Röh and Vogel, n 191 above, s 33/23; H. Hirte in H. Hirte and C. von Bülow (eds), *Kölner Kommentar zum WpÜG* (Cologne: Carl Heymanns, 2003), s 33/27-28; R. Steinmeyer in Steinmeyer and Häger (eds), n 191 above, s 33/6.

[235] See, eg, Krause and Pötzsch, n 90 above, s 33/17, 87; A. Schwennicke in Geibel and Süßmann (eds), n 191 above, s 33/18.

[236] Bundestags-Drucksache 14/7477, 25.

[237] Takeover Act, s 33(1).

[238] Bundestags-Drucksache 14/7477, 53.

In this respect, there is some overlap with *Holzmüller*, which also refers to duties, namely the duty of the management board to procure a decision of the general meeting under certain conditions.[239] In contrast to the express provisions of the Stock Corporation Act that require shareholder approval,[240] this duty-based approach does not interfere with the power of the management board to effect transactions on behalf of the company that are legally binding in relation to third parties.[241] However, *Holzmüller* has a second dimension that was emphasised by the subsequent *Gelatine* judgments.[242] Non-compliance with the *Holzmüller* duties interferes with the *membership rights* of the shareholders, with the consequence that they have standing to sue, whereas a violation of the neutrality rule does not give rise to claims of the shareholders (but only to claims of the company for breach of directors' duties).[243] That is, one reading of *Holzmüller* is that it is based on a theory of authority or competences, namely that the board does not have the authority to take the action where it interferes with the fundamental rights covered by *Holzmüller*. If this is the correct reading of *Holzmüller*, then the Takeover Act would not cover any defensive action that falls within *Holzmüller*. That is, the Takeover Act would not be deemed to authorise defensive board action that affects fundamental shareholder rights, because the Act only authorises the board to use the powers *that it has* defensively. Indeed, consistent with this view the literature assumes that the 'classical' *Holzmüller* doctrine, requiring shareholder approval for reorganisations involving transfers of assets exceeding 75-80 per cent of total assets, is of continued validity and constrains the discretion of the management board to adopt defensive measures, even where the supervisory board gives their consent.[244] If this is correct, then *Holzmüller* could continue to operate as a general restriction on the use of takeover defences as outlined above.

Such a reading would, of course, create a conflict between the legislative approval of defensive action and a judicial rule that provides that boards do not have authority to take steps that have defensive effects. It is clearly possible, if not probable, that the courts would side with the legislative provision or take a narrow reading of *Holzmüller* in those circumstances. A third possibility is that an authority restriction based on *Holzmüller* would remain, but would only be triggered where the defensive action involved a particularly potent interference with shareholder rights, such as a poison pill, but not where the defence was less potent, for example, in relation to a low percentage share issue or buy-back. Given the difficulty of constructing potent defences in Germany, one suspects that we may have to wait a long time to obtain judicial resolution of these difficult issues.

---

[239] See n 204 above.
[240] For example the Stock Corporation Act, s 179a.
[241] Takeover Act, s 82(1).
[242] See nn 204, 213 above.
[243] Stock Corporation Act, s 93(2). For an overview of these problems, see Krause and Pötzsch, n 90 above, s 33/304-321.
[244] Krause and Pötzsch, ibid, s 33/50 (n 8); Röh and Vogel, n 191 above, s 33/85, 90. The same reasoning applies with respect to the *Kali und Salz* requirements.

3.2.5 The post-Takeover Act 2001 position

General principles of corporate law that do not explicitly address board neutrality and that are not in conflict with the will of the legislator of the 2001 Act continue to apply and constrain the discretion of the directors as they take decisions within the parameters of the Takeover Act.[245] Important, particularly with regard to future changes in corporate law that could render a poison pill more readily available than it is today, is the general principle of equal shareholder protection. As we have seen above, the standard poison pill arrangement is unavailable pursuant to German Corporate law. Small changes in German corporate law could, however, *but still with ex-ante shareholder approval*, make them available. German law would simply need to be amended to allow the issue of naked warrants.

Poison pills are effective because they exclude the right of the bidder who crosses the trigger threshold to purchase voting equity in accordance with the terms of the warrant. While we have argued that there are good reasons to assume that a pill would not be considered discriminatory in the United Kingdom, since it gives all holders of shares the same (conditional) right to buy additional shares, the issue may well be assessed differently in Germany. The equal treatment principle laid down in the Stock Corporation Act is phrased more broadly than its UK counterpart, requiring that 'shareholders shall be treated equally under equal conditions'.[246] Thus, as opposed to the UK Listing Authority's Listing Rules, the requirement does not refer to 'the rights attaching to [shares]', but more generally to 'shareholders'. Unequal treatment may not only result from an explicit differentiation between groups of shareholders and the rights attaching to their shares, but also from provisions that impose a *de facto* disadvantage on some shareholders but not on others that derives, for example, from the size of their shareholding.[247]

The implications of the equal treatment principle for shareholder rights plans or dilutive warrants issued by convertible bonds have not been evaluated by the courts, but a decision of the Federal Court of Justice from 1977 (*Mannesmann*) bears a certain resemblance to the problem here at issue and might prove

---

[245] See the explanatory memorandum of the draft Takeover Act, Bundestags-Drucksache 14/7034, 58; and from the literature, eg, Krause and Pötzsch, ibid, s 33/50-52; Röh and Vogel, ibid, s 33/24; Hirte, n 234 above, s 33/28, 72-73.

[246] Stock Corporation Act, s 53a, implementing the Second Company Law Directive, Directive 77/91/EEC of 13 December 1976, 1977 OJ L 26/1, art 42. While the equal treatment principle was not expressly included in the Stock Corporation Act before implementation of the Directive in 1978, it has for a long time been part of the courts' jurisprudence. For decisions discussing the principle before adoption of s 53a see, for example, Imperial Court (RG), RGZ 113, 152, 156; 118, 67, 70; 120, 177, 180; Federal Court of Justice (BGH), BGHZ 20, 363, 369; 120, 141, 150; and Federal Constitutional Court (BVerfG), BVerfGE 14, 263, 285.

[247] This is commonly acknowledged in the literature. See, eg, A. Cahn and M.A. Senger in Spindler and Stilz (eds), n 133 above, vol 1, s 53a/24-26, for references. The authors speak of 'formal' and 'material' differentiation, the latter referring to what we call '*de facto* disadvantage'.

instructive.[248] The case dealt with the introduction of a voting cap in order to insulate the company from control changes at a time when the shareholding of at least one investor already exceeded the quota thus established. The Court held that under these circumstances the voting cap constituted differential treatment that interfered potentially significantly with the voting rights of shareholders.[249] In other words, even though the measure did not differentiate between shareholders formally, it fell within the ambit of the equal treatment principle because its *effects* on voting rights were different depending on the size of the shareholding.

However, simply because corporate action implicates the equal protection provision does not mean that it violates the statute. The courts have stressed that the equal treatment principle only prohibits the general meeting and the management board from distinguishing between shareholders in an *arbitrary* manner, ie without objective justification.[250] In *Mannesmann* the differential treatment was justified because it was held to be necessary 'to shield the company from external forces obtaining control, strengthen the independence of the management board, and protect small shareholders against the dominating influence of blockholders'.[251] While this holding is relatively permissive, it is important to note that the voting cap was introduced by resolution of the general meeting, not by board action. Based on the limited authority available, German courts would impose a more demanding standard on the use of board-controlled takeover defences if they resulted in the disenfranchisement or dilution of particular of shareholders. This can be seen clearly in the case of the exclusion of pre-emption rights and allotment of shares to selected shareholders, which needs to be justified in accordance with the principles established by the *Kali und Salz* line of cases.[252]

Accordingly, in our view, there is reason to think that a standard poison pill (assuming it could be put in place) would violate the German equal protection of shareholders provision unless the shareholders explicitly authorised their issue as a defensive measure, or the bidders' actions represented a serious threat to the company as a going concern.

3.3 PRACTICAL EFFECTIVENESS

The discussion so far has shown that even in the absence of an express duty of neutrality the availability of most takeover defences is restricted. Therefore, the

---

[248] Federal Court of Justice (BGH), BGHZ 70, 117.
[249] ibid, 121.
[250] See, eg, Imperial Court (RG), RGZ 68, 210, 212 and Federal Court of Justice (BGH), BGHZ 33, 175.
[251] BGHZ 70, 117, 122-123.
[252] See the text to nn 166-184 above. A controversial case, albeit one decided before *Kali und Salz*, is BGHZ 33, 175 (*Minimax II*), where the Federal Court of Justice allowed the board to make a non-pre-emptive issue to particular shareholders that were affiliated with the board in order to defend against a hostile bid. The Court held that, in allotting shares, the board had a duty not to favour some shareholders over others. However, the unequal treatment was justified in the case at hand in light of the egregious behaviour of the bidder, which, for example, included aggravating the financial difficulties of the target in order to achieve its goal of acquiring and breaking up the company. See ibid, 186-188.

question whether, and to what extent, the defences would be practically effective is a largely theoretical exercise. All of the defence types addressed in this paper are subject to significant restrictions on availability and use. There is little that is formally available. What is formally available is of limited potency. However, for purposes of completeness we consider briefly the issue of practical effectiveness under German corporate law.

In several respects, German law is less shareholder-friendly than that of the United Kingdom when it comes to the removal of directors. Since the members of the management board are appointed by the supervisory board,[253] the first step toward replacing the management of the target company is the replacement of the members of the supervisory board.[254] Supervisory board members serve a maximum term of five years.[255] The articles may provide for a staggered board, although this is not common in German companies.[256] A bidder who obtains a qualified majority can, of course, amend the articles and repeal the staggered board provision. The members of the supervisory board can be removed before expiration of their term of office without cause by three-fourths majority.[257] However, the new supervisory board, in turn, can only remove the members of the management board for 'an important reason' before their term of office expires.[258] A change of control is not considered an 'important reason'.[259] Therefore, the bidder in general needs to procure a vote of no confidence by the general meeting, which will then enable the supervisory board to remove the members of the management board.[260] Note in this regard that five per cent of the shareholder body has a mandatory right to call a shareholder meeting.[261]

Finally, apart from the cases specified in the Stock Corporation Act (and extended by *Holzmüller*) that require shareholder approval, the general meeting does not have the right to engage in decision-making unless requested to do so by the management board.[262] Therefore, as mentioned, the shareholders are not entitled to give instructions to the management board and cannot instruct management to remove defences that have been put in place earlier.

Accordingly, board members that deploy the available defences benefit from a greater degree of removal protection than the board of a UK company. However, as compared to the protection which Delaware removal rights provide Delaware directors, directors of widely-held German companies are more exposed. In contrast to a Delaware corporation with a staggered board, they could

---

[253] Stock Corporation Act, s 84.
[254] In companies that are subject to co-determination the bidder can only replace the shareholder-appointed members of the supervisory board. See ibid, ss 95-96.
[255] ibid, s 102.
[256] Hirte, n 234 above, s 33/177.
[257] Stock Corporation Act, s 103(1).
[258] ibid, s 84(3).
[259] Raiser and Veil, n 212 above, s 14/39.
[260] Stock Corporation Act, s 84(3).
[261] ibid, s 122(1).
[262] ibid, s 119(2).

all be removed at any time by a shareholder meeting committed to their removal – enabling the redemption of any pill that is put in place – and they cannot, as many Delaware directors can, take comfort in a guaranteed cool-off period, until the next annual shareholder meeting, following the successful defence of a bid.

3.4 SUMMARY

If the Takeover Directive provided for a mandatory board neutrality rule it would have the important effect of removing the Takeover Act 2001. However, its actual impact on the contestability of *widely-held* German companies would be limited. US-type poison pills are not available because they require a flexibility that the German corporate law cannot offer. A qualified version of the pill could, albeit with some practical difficulty, be put in place through an *ex ante* nominal convertible bond issued with shareholder approval. If the practical difficulties can be overcome, any such constructed defence requires explicit *ex-ante* shareholder approval and is subject to *ex-post* constraint of the equal protection standard. As far as the equity restructuring defence is concerned, the Stock Corporation Act provides for *ex-ante* shareholder approval. Shareholders could, if concerned about *ex-post* manipulation of the authorisation, place conditions on the authorisation. If the management board has been authorised to allot shares and exclude pre-emption rights, the case law developed by the Federal Court of Justice has, in relation to greater than 10 per cent non-pre-emptive issues, supplemented the statutory provisions with duties that require the proportionality of the decision of the management board and a description of the envisaged use of the authorisation in the resolution creating the authorised capital. Furthermore, as the recent Hochtief-ACS takeover demonstrates, a 10 per cent share issue defence has a limited defensive impact.

Of the three takeover defences analysed in this article, only the crown jewels defence, the least potent defensive tactic, can potentially be deployed by management without *ex-ante* or *ex-post* shareholder involvement. However, the courts have refined the statutory allocation of competences and require shareholder approval where the transaction interferes fundamentally with membership rights, which is understood to mean where the value of the assets exceeds the high threshold of 75-80 per cent, and the sale has an 'intermediating effect'.[263] Directors using these defences in the face of a shareholder base that wishes to accept the offer may feel safer in their jobs than would their UK counterparts (in the absence of the UK non-frustration principle) but will be far less secure than their Delaware counterparts. They are likely to use them for entrenchment purposes rather warily.

In relation to even these limited formally available defences, in the pre-2001 German corporate legal context, such defences would, we have argued, have been subject to significant principled-based constraints. These constraints were partly

[263] See n 215 above.

disposed of by the 2001 Act. While German corporate law maintains even today a strong anti-takeover defence bias, as it limits the construction of these defences, it seems likely that had the Commission never started its Takeover Directive journey, German corporate law's anti-defence bias would have been even stronger.

4. DOES ITALY'S OPT-OUT FROM THE BOARD NEUTRALITY RULE MATTER?

The newly enacted regime implementing the Takeover Directive, which came into force in July 2010, does not impose a mandatory board neutrality rule and makes the reciprocity exception available.[264] This approach closely mirrors the principles underlying the 2008 reform[265] of the original transposition of the Takeover Directive.[266]

The initial implementing rules, which came into effect in December 2007, were based on a strong non-frustration principle,[267] with a reciprocity option,[268] and essentially confirmed the pre-existing takeover regime.[269] Unless authorised by a post bid[270] resolution adopted by shareholders representing at least 30 per cent of the company's outstanding share capital, directors of an Italian listed company

---

[264] Consolidated Financial Services Act No 58 of 1998 (hereinafter, the 'CFSA'), art 104.

[265] Law Decree No. 185, art 13, 29 November 2008 (published in the S.O. no. 263/L to the G.U. no. 280 of 29.11.2009) converted into the Law No. 2 of 28.1.2009 (published in the S.O. no. 14/L to the G.U. no. 28.1.2009), which amended CFSA (2007 version), arts 104, 104*bis*, 104*ter*.

[266] See Law Decree No. 229, 19 November 2007 (published in the G.U. no. 289 of 13.12.2007), which amended CFSA (pre-2007 version), art 104 and introduced CFSA, arts 104*bis*, 104*ter*.

[267] CFSA (2007 version), art 104.

[268] CFSA (2007 version), art 104*ter*. It is uncertain whether this option is permitted by the Takeover Directive, arts 12(2), 12(4), when the 'opt-in' choice is made by the Member State. See J. Rickford, 'The Emerging European Takeover Law from a British Perspective' (2004) 15 *EBLR* 1396. Similar arguments in the Italian literature during the 2007 regime can be found in M. Lamandini, 'Legiferare per "Illusione Ottica"? OPA e Reciprocita' "Italiana"' (2008) 1 *Giurisprudenza Commerciale* 240.

[269] CFSA (2007 version), art 104 (1). See C. Mosca, 'Commento *sub* Article 104' in P. Marchetti and L. Bianchi (eds), *La Disciplina delle Societa' Quotate nel Testo Unico della Finanza d.lgs. 24 febbraio 1998 n. 58* (Milan: Giuffre', 1999); A. Portolano, 'Un'Analisi Economica della "Passivity Rule" nel Testo Unico della Finanza' (2000) 1 *Mercato Concorrenza e Regole* 39; M. Gatti, 'La Societa' Target in Pendenza di Offerta Pubblica d'Acquisto' (2000) *Giurisprudenza Commerciale* 632; E. Desana, *Opa e Tecniche di Difesa* (Milan: Giuffre', 2003), 127; and F.M. Mucciarelli, *Societa' per Azioni e Offerta Pubblica di Acquisto* (Milan: Giuffre', 2004), 153. A comprehensive account of the Italian debate on the scope of the Takeover Directive can be found in A. Angelillis and C. Mosca, 'Considerazioni sul Recepimento della Tredicesima Direttiva in Materia di Offerte Pubbliche di Acquisto e sulla Posizione Espressa nel Documento della Commissione Europea' (2007) *Rivista delle Societa'* 1106. The 1998 regime provided by the CFSA relaxed the pre-existing strict passivity principle set out in Law No. 149 of 1992, art 16. See F. Vella, 'La Passivity Rule nella Legge Italiana sulle Opa e gli Effetti sul Mercato del Controllo Societario' (1993) *Banca, Impresa e Società* 217; C. Salomao Filho and M. Stella Richter, 'Note in Tema di Offerte Pubbliche di Acquisto, Ruolo degli Amministratori ed Interesse Sociale' (1993) *Rivista di Diritto Commerciale* 113; and A. Tron, 'La Legge n. 149/1992 e le Strategie "Antiscalata": un'Analisi Comparata della Regolamentazione Attuale' in C. Rabitti Bedogni (ed), *Il Diritto del Mercato Mobiliare* (Milan: Giuffre', 1997), 248.

[270] That is, following the time of the communication of the bid to CONSOB – CFSA (2007 version), art 104.

had to refrain from taking corporate actions which might result in the frustration of the bid.

It was the credit crisis that brought about a 'change of heart' in relation to the board neutrality rule in 2008.[271] Concerns about the vulnerability of Italian companies to takeovers following the fall in stock prices resulted in Italian regulators electing to make the board neutrality rule optional and allowing companies who opted-in to subject the opt-in to a reciprocity requirement.[272]

The protectionist trend, albeit in a watered down version,[273] continues under the current regime where both the non-frustration and the breakthrough rules remain optional.[274] What has changed is the direction of choice in implementing the opt-out mechanism offered by the Takeover Directive.[275] Italian companies are now subject to the board neutrality rule, unless they opt-out of the provision by amending their articles of association.[276] The reversal in the board neutrality opt-in arrangements adopted in 2008 addressed a specific corporate governance issue.[277] In the case of a company with a concentrated share ownership structure, which is typical in Italy, controlling shareholders with significantly less than 50 per cent of the voting rights could block any opt-in resolution. Moreover, in the absence of any board initiative, the requirement for a supermajority vote exacerbated coordination problems among shareholders, rendering the (opt-in) option *de facto* unavailable.[278] By making the board neutrality rule the default rule the 2010 reforms alleviate this problem. A resolution passed with the support of two-thirds of the votes cast at the meeting,[279] is now required to opt-out of the board neutrality rule.[280]

Where a company has not opted-out of the neutrality rule, the 2010 implementing legislation provides exceptions to the strict prohibition which are consistent with those permitted by the Takeover Directive, namely seeking alternative bids,[281] and the implementation of any decision taken before the start of bid which falls within the normal business practices of the company.[282] In short, unless a company has opted-out of the neutrality rule, in Italy the board of the target company is not allowed to take any action which may result in the

---

[271] See Circolare Assonime 18 April 2009, 'Le Modifiche alla Disciplina sull'Opa: Regola di Passivita', Regola di Neutralizzazione e Reciprocita' (decreto anticrisi n.17 del 29 novembre 2008)' at <http://www.emagazine.assonime.it/upload/circolare18_2009.pdf, visited on 6 April 2011>.

[272] CFSA (2008 version), arts 104 (1), 104*bis*, 104*ter*.

[273] See Davies, et al, n 10 above .

[274] CFSA, arts 104, 104*bis*. See A. Morello, 'Scalate Ostili e Misure Difensive: dalla Direttiva OPA al Decreto 146/09' (2010) *Le Societa'* 158, and F. Mucciarelli, 'La Disciplina dell'Offerta Pubblica d'Acquisto' (2010) *Le Nuove Leggi Civili Commentate* 92.

[275] Takeover Directive, arts 12 (1), 12 (2).

[276] CFSA, arts 104 (1), 104 (1)*ter*.

[277] See Mucciarelli, n 274 above, 101.

[278] This is also supported by the lack of cases in which the shareholders have opted back into the board neutrality rule when the Member State has opted-out. See Davies, et al, n 10 above

[279] See Civil Code, arts 2368 (2), 2369 (3), 2370.

[280] CFSA, art 104 (1) *ter*.

[281] CFSA, art 104 (1) and Takeover Directive, art 9 (2).

[282] CFSA, art 104 (1) *bis* and Takeover Directive, art 9 (3).

frustration of a takeover bid if it has not been authorised by a post-bid shareholder resolution.[283]

The history of Italian takeover defence regulation in the last five years takes us through all the available board neutrality rule options available: a mandatory rule, its default non-application, and finally its default application. The question we ask in this section is whether when one takes into account the background corporate law rules in Italy, do any of these approaches matter very much to the contestability of Italian companies? Do any of these three choices make more than a trivial difference to the defensive capabilities of an Italian board? Following the structure set forth in the other sections of this article we ask whether under Italian corporate law our identified defence types are formally available, whether they can be deployed by the board, and if deployed whether they are practically effective.

4.1 Formal availability

4.1.1 An Italian poison pill?

It is uncertain whether a typical US-style shareholder rights plan complies with Italian law. As the lack of case law suggests, the issue is more of theoretical interest than of practical significance.

Poison pills involve the issuance of warrants as interim dividends to all existing shareholders. This is possible under Italian law. The general principle is that dividends are payable (even in kind) when declared by an ordinary resolution passed by the general meeting that approves the annual accounts, provided that accumulated profits have been actually made and duly documented in the balance sheet.[284] If the articles so permit, directors of listed companies can distribute interim dividends when the previous financial year's approved audited accounts do not show losses relating to that fiscal year or the previous fiscal years.[285] The articles of association of Italian listed companies would typically provide such authority to the directors.

Whilst the default rule is that shareholder authorisation (to raise capital,[286] and to grant options) is required under Italian law, the articles (or a subsequent amendment of the articles,[287] adopted by supermajority resolution passed by two thirds of the votes cast at the meeting)[288] may also authorise the board to increase capital one or more times, up to a specified amount,[289] and within a maximum period of five years from the date of incorporation or the amending resolution.[290] If such authorisation is not large enough to support the granting of an option to

[283] CFSA, art 104 (1).
[284] Civil Code, arts 2433 (1), (2).
[285] ibid, arts 2433*bis* (1), (2), (3).
[286] ibid, art 2365 (1).
[287] ibid.
[288] ibid, arts 2368 (2), 2369 (3), (7).
[289] Typically, this amount will be lower than the existing capital.
[290] Civil Code, art 2443.

buy a share for every existing issued share, the board would have to return to the shareholder body to obtain an additional authorisation and in the process of so doing would clearly have to explain the purpose behind the increased authorisation.

Once in place, there is, however, some uncertainty about whether the pill could be effectively triggered because it is not clear that the bidder can be excluded from exercising the warrants and whether shares can be issued at a discount to the current market price. Two positions can be broadly identified. The conventional view is sceptical on the availability of a typical US-style shareholder rights plan in Italy,[291] and argues that it probably violates the default principle of equal treatment among shareholders.[292] More specifically, it maintains that in order to exclude the bidder from exercising the warrants and purchasing newly issued shares for cash, pre-emption rights have to be waived just as they do under the ordinary rules for the raising of share capital. This is possible only in two circumstances. First, when the articles, or a subsequent shareholder resolution,[293] allow the board to issue shares to raise capital in an amount not exceeding 10 per cent of the outstanding shares, and the issue price is equal to the market value of the shares as stated in a special report certified by an auditing company.[294] Secondly, 'when the interest of the company requires it', and the authority has been granted to the board by a resolution passed by shares representing more than half of the company's outstanding capital.[295] These exceptions, however, are of limited assistance in constructing an effective poison pill. The 10 per cent cap imposed by the first exception is insufficient to issue a pill, and the restriction on issuing shares at a discount removes the dilutive effect of the pill, rendering it completely ineffective.[296] The second exception requires a resolution passed by 50 per cent of the company's outstanding capital to authorise the board to issue the shares non-pre-emptively and, in addition, shares must be issued at a price calculated on the basis of the net value of the assets, having regard to the share price trend during the last semester (*emissione con sovrapprezzo*).[297] Again, this destroys the dilutive effect of the pill.

The above orthodox approach has been recently challenged. Some commentators have suggested that a shareholder rights plan does not *per se* infringe the principle of equal treatment among shareholders, nor does it necessarily violate the pre-emption right principle.[298] These commentators argue that the execution of the plan is the outcome of a contractual arrangement entered into between the company and the shareholders which provides that on the

---

[291] See Desana, n 269 above, 187 and G. Ferrarini, 'Le Difese Contro le O.P.A. Ostili: Analisi Economica e Comparazione' (2000) *Rivista delle Societa'* 776.
[292] CFSA, art 92.
[293] Requiring two-thirds of the votes cast.
[294] Civil Code, art 2441 (4).
[295] ibid, art 2441 (5).
[296] As it is, instead, in a typical US-style shareholder rights plan.
[297] Civil Cod, art 2441 (6). See E. Ginevra *Sottoscrizione e Aumento del Capitale Sociale nelle S.p.A.* (Milan: Giuffre', 2001), 156. and G. Mucciarelli, *Il sopraprezzo delle Azioni* (Milan: Giuffre', 1997), 183.
[298] See M. Gatti, *Opa e Struttura del Mercato del Controllo Societario* (Milan: Giuffre', 2004), 356.

occurrence of a triggering event the party that crosses the specified ownership threshold will be prevented from exercising the warrants and from subscribing for the newly issued shares.[299] In line with the *ratio* of the Delaware Supreme Court decision in *Baker* v *Providence & Worcester*,[300] which distinguished between discrimination among shareholders (legal) and discrimination among shares (illegal), in the case of a takeover bid discriminating amongst shareholders 'who are not in the same conditions' ('*che non si trovino in identiche condizioni*') does not infringe the principle of equal treatment among shareholders 'in the same conditions' ('*che si trovino in identiche condizioni*') established by Article 92 CFSA.[301] Moreover, for proponents of this position when the warrants are issued, pre-emption rights are also protected as they are issued proportionately to all the shareholders (*aumento di capitale riservato al servizio del warrant*). It is only on the occurrence of the triggering event that the contractual provisions contained in the shareholder rights plan (well known *ex ante* to shareholders) will prevent the bidder from exercising the warrants. Pre-emption rights are in this case 'absorbed' into the contractual options (*opzioni di secondo grado*) set forth in the warrants.[302]

Although the proponents of validity put forward a strong case, the concerns articulated by the conventional view are difficult to entirely rebut. The issuance of warrants pursuant to a shareholder rights plan is likely to be seen by the courts as a way of (contractually) circumventing pre-emption rights.[303] This obstacle should not be underestimated because the implementation of a shareholder rights plan following a triggering event by issuing shares at a discount would infringe the rules on the pricing of shares when pre-emption rights are waived (*emissione con sovrapprezzo*).[304]

4.1.2 Equity restructuring

Equity restructuring defences in Italy are all subject to a significant degree of shareholder control. As noted above in the analysis of poison pills, article 2443 of the Civil Code provides that the articles (or a supermajority resolution that alters the articles) can confer on the directors the power to allot new shares one or more times, up to a specified amount and within a specified period of up to five years. It is common that in listed companies this power is granted on a rolling basis although, as a survey on the articles of the companies comprised in the FTSE MIB

[299] On this issue (albeit outside the realm of takeover bids), see P. Marchetti, 'Aumenti di Capitale ad Esecuzione Differita: Warrant, Opzione Indiretta' (1993) *Rivista del Notariato* 223.
[300] 378 Del Supr A 2d 121 (1977).
[301] That is: 'listed issuers shall guarantee equal treatment to all holders of financial instruments who are in the same conditions'. This issue is also discussed by C. Angelici, 'Parita' di Trattamento degli Azionisti' (1987) *Rivista di Diritto Commerciale* 12.
[302] The mechanism is explained by Marchetti, n 299 above, 225 and F. Guerrera, *I Warrants Azionari nelle Operazioni di Aumento di Capitale* (Torino: Giappichelli, 1995), 85.
[303] Guerrera, ibid, 106.
[304] This is also the argument put forward by Gatti, n 298 above, 364.

index[305] shows, apart from a few exceptions,[306] the rolling authorisations are typically lower than in the UK.[307] That said, as in the UK, shareholders have the power to subject such authorisation to conditions,[308] and may retain the power to revoke (or to adjust the terms of) the authority granted to the directors until shares have been allotted.[309]

Article 2443 of the Civil Code also provides that the pre-emption rights of existing shareholders may be waived in a number of cases when the guidelines set forth in the articles are followed by directors (*i criteri cui gli amministratori devono attenersi*).[310] First, if shares are issued for in-kind consideration, and the reasons for the exclusion and the methods adopted for the determination of the issue price are clearly stated.[311] Second, where the articles, or a super majority shareholder resolution,[312] authorise the board to issue shares amounting to less than 10 per cent of the outstanding share capital, provided that the issue price is equal to the market value of the shares, and this is certified by a special report of the company's auditors.[313] A survey of the articles of the companies comprised in the FTSE MIB index shows that the authorisation required for the board to make use of this exception is not often inserted in the companies' articles. Rolling shareholder waivers of pre-emption rights of this kind are relatively rare.[314] Third, if the 'interest of the company requires it' when directors have been authorised by a resolution passed by a majority of fifty per cent of the company's *outstanding capital* which specifies the criteria to be followed by the directors for indentifying the purchasers and for determining the issue price.[315]

In Italy therefore, as in the UK, *in theory*, there is scope for management to use the rolling grants of authority to allot shares coupled with the formal availability of the exceptions to the pre-emption regime for defensive purposes. Importantly, as in the UK, Italian corporate law provides the means to control any

---

[305] It is the primary benchmark Index for the Italian equity markets (about 80 per cent of the domestic market capitalisation), and it is based on the performance of 40 companies.

[306] These are companies (eg Ansaldo STS S.p.A., Campari S.p.A., CIR S.p.A., EXOR S.p.A., and Italcementi S.p.A.) where the size of the rolling authorisation is significant (greater than the company's outstanding capital).

[307] That is, less than 20 per cent (eg Fiat S.p.A., Enel S.p.A., Assicurazioni Generali S.p.A., Telecom Italia S.p.A., and UniCredit S.p.A.).

[308] See A. Esposito, *Art 2443* in G. Fauceglia and G. Schiano di Pepe (eds), *Codice Commentato delle S.p.A.* (Torino: Utet, 2007), vol II, 1316. See also G.D. Mosco, *Le Deleghe Assembleari nella Società per Azioni* (Milan: Giuffre', 2000), 135 and B. Quatraro, R. Israel, S. D'Amora, and G. Quatraro, *Trattato Teorico Pratico Delle Operazioni sul Capitale* (Milan: Giuffre', 2001), 484.

[309] See M. Arato, 'Modificazioni dello Statuto e Operazioni sul Capitale' in O. Cagnasso and L. Panzani (eds), *Le Nuove S.P.A.* (Bologna: Zanichelli, 2010), 1356, where additional references can be found.

[310] Or in subsequent amendments of the articles. See Massime del Consiglio Notarile di Milano, 'Delega agli Amministratori ex art. 2443 c.c. di Aumento di Capitale con Esclusione del Diritto di Opzione' (2004) at <http://www.scuoladinotariatodellalombardia.org/ParteI.htm#8> (last visited 6 April 2011).

[311] Civil Code, art 2441 (4). The formalities for the evaluation of contributions in kind are set under the Civil Code, arts 2441 (6), 2443 (4) as amended pursuant to the Legislative Decree No. 224, 29 November 2010, art 1.

[312] Two-thirds of the votes cast. Civil Code, arts 2368 (2), 2369 (3), (7).

[313] ibid, art 2441 (4).

[314] Less than one-third of articles of the companies included in the FTSE MIB index.

[315] Civil Code, art 2441 (5).

'abuse' of this defensive capability. Any perception of managerial abuse could result in a reduction in such rolling grants, or where such rolling grants are viewed as important for other business purposes, a market practice of more restrictive conditions being applied to such grants could develop. Given the current context of Italian ownership structures,[316] it is of course difficult to predict such behavioural patterns.

With regard to share buy-backs to enhance the proportionate ownership of a friendly shareholder or insider, or to effect green mail, under Italian corporate law it is not possible for a company to purchase its own shares using its financial resources without shareholder approval.[317] Such repurchases can only be made out of profits available for distribution,[318] and within the quantitative (the maximum number of shares to be purchased) and temporal (the period of the authorisation cannot exceed 18 months) boundaries set forth in a shareholders' resolution.[319] The number of the shares purchased cannot exceed 10 per cent of the share capital, which for the purpose of this calculation includes the treasury shares already held by company and its subsidiaries.[320]

4.1.3 Asset sales/crown jewels defences

The general difficulties of deploying an asset sale defence in any jurisdiction have been noted above. However, these difficulties notwithstanding, the defence is formally available to an Italian company as under Italian law there is no shareholder approval requirement for an asset sale when the sale is made in pursuit of the corporate objects (*in attuazione dell'oggetto sociale*).[321]

---

316 A number of empirical studies have shown that Italy is a concentrated shareholder jurisdiction where the majority of listed companies have a controlling shareholder. Under these circumstances, the typical shareholder/board agency issues do not arise as the controlling shareholder has a direct incentive to closely monitor the directors' actions and, in particular, the power and interest to directly replace the inefficient management. An introductory analysis of the ownership structure of Italian companies is offered by L. Enriques and P. Volpin 'Corporate Governance Reforms in Continental Europe' (2007) 21 *Journal of Economic Perspectives* 117, where reference is also made to pyramidal ownership as a common way of holding control in Italy. See also M. Bianchi, M. Bianco, S. Giacomelli, A.M. Pacces, and S. Trento, *Proprietà e Controllo delle Imprese in Italia* (Bologna: Il Mulino, 2005); M. Becht, M. Bianco, and C. Mayer, 'Il Controllo delle Imprese Europee' (2001) *Banca Impresa e Societa'* 221; and L. Caprio, 'La Struttura Proprietaria delle Societa' Quotate Italiane: Quali Evoluzioni Recenti?' (2001) 2 *Banca Impresa e Societa'* 199.

317 Civil Code, art 2357*ter* (1). See F. Carbonetti, *L'acquisto di Azioni Proprie* (Milan: Giuffre', 1988). On the specific scenario of a takeover bid, see G. Carcano, 'Acquisto di Azioni Proprie come Tecnica di Difesa dale Scalate: la CEE Rafforza il Divieto' (1992) *Rivista delle Societa'* 1310.

318 Civil Code, art 2357 (1).

319 ibid, art 2357 (2).

320 ibid, art 2357 (3).

321 ibid, art 2380*bis*. And even if this is not the case (ie the sale is not made with the view of reaching the corporate object), the sale cannot be clawed back unless it is proved that the purchaser acted intentionally together with the directors to the detriment of the company (*exceptio doli*). ibid, art 2384 (2). See F. Bonelli, *Gli Amministratori di S.p.A.* (Milan: Giuffre', 2004), 17.

4.2 General corporate legal restraints on the use of the board controlled defences

The default position under Italian law is that the directors are responsible for the management of the company,[322] unless otherwise provided by law,[323] or by the company's articles. This position was reinforced in the 2003 Company law reform, which greatly eroded the power of the general meeting to interfere with the management of the company.[324] In this section, we ask whether there are any generally applicable restrictions on the exercise of these powers for defensive purposes. More specifically we ask whether the exercise of the powers for defensive purposes is restricted by obligations of loyalty or other rules requiring shareholder involvement when powers are used defensively.

It is disputed whether Italian law adopts a different standard of review for the duty of loyalty and the duty of care. In the past this was not the case, and the standard for both duties was based on an objective diligent director standard set forth in article 1710 of the Civil Code (*diligenza del mandatario*).[325] Managerial discretion was permitted on rather unsettled grounds by reference to the general principles on the law of obligations (*obbligazioni di mezzi*). That said, following the Company law reform in 2003, it has been argued that a distinction between the two duties can be drawn even in the absence of provisions in the Code to this effect.[326] More specifically, it has been suggested that the duty to manage the company in pursuit of the company's objects (*le operazioni necessarie per l'attuazione dell'oggetto sociale*)[327] can be identified as the source for the duty of loyalty. If this view is correct, then it is surely a subjective duty:[328] it is what the actual director believed in good faith to be the company's best interest at the time the decision was taken. Accordingly, any exercise of power for defensive purposes must comply with the (objective/subjective) standard of care of a diligent manager,[329] and although there is some residual uncertainty in this regard, be taken in what the director believes furthers the company's objects.

Notwithstanding the aforementioned uncertainty regarding the role of a loyalty obligation in directors' decision-making and the director primacy bias of

---

322 Civil Code, art 2380*bis*.
323 eg ibid, arts 2364, 2365.
324 This has been for example with respect to the issuance of debentures. ibid, art 2410. Further evidence of this 'trend' can be found when considering the creation of 'dedicated assets to a specified business' (ibid, art 2447-*ter*) and the issuance of 'special financial instruments' (ibid, art 2346 (6)), which belong to exclusive competence of the directors. See M. Libertini, 'Scelte Fondamentali di Politica Legislativa e Indicazioni di Principio nella Riforma del Diritto Societario del 2003. Appunti per un Corso di Diritto Commerciale' (2008) *Rivista del Diritto Societario* 232 and C. Angelici, 'Introduzione alla Riforma delle Societa' di Capitali' in P. Abbadessa and G.B. Portale (eds), *Il Nuovo Diritto delle Societa'. Liber Amicorum Gian Franco Campobasso* (Torino: Utet, 2006), 3.
325 See V. Allegri, 'Contributo allo Studio della Responsabilita' Civile degli Amministratori' (Milan: Giuffre', 1979), 139.
326 See C. Angelici, '*Diligentia Quam in Suis* e Business Judgment Rule' (2006) *Rivista del Diritto Commerciale* 675.
327 Civil Code, art 2380*bis* (1).
328 See Angelici, n 326 above, 690.
329 Civil Code, art 2392 (1).

contemporary Italian corporate law, the Civil Code imposes some indirect restrictions on board action by encouraging, in certain circumstances, shareholder involvement in the decision-making process. Before the enactment of the Company law reform in 2003, Article 2364 no. 4 of the Civil Code provided for the possibility of *ex ante* shareholder ratification of board decisions (especially) when there was scope for controversy as to whether the matter in question was a matter for managerial discretion or rather involved essential shareholder interests.[330] The meaning and effect of the rule was, however, unclear. In the absence of a significant body of case law,[331] commentators put forward two different interpretations. One view argued for the exclusive managerial competence of the directors,[332] dismissing the need for shareholder authorisation unless it was obtained in order to provide directors with a liability waiver against possible future claims. Another, and more convincing interpretation,[333] suggested that even in the absence of a specific mandatory requirement, the need for shareholder authorisation under certain conditions was indispensable to fulfil the general directors' duties and good faith (*regole generali di comportamento che sovraintendono la condotta degli amministratori e il principio di buona fede*). In this respect, the list of circumstances broadly included decisions of fundamental interest for the company (*interesse primordiale dei soci*),[334] such as the sale of essential company assets. In our view, pre-2003 a strong case could be made that Article 2364 no. 4 could be read to require shareholder approval for the use of defences to intentionally interfere with a takeover bid. At a minimum it would have constrained the use of a substantial asset sale defence, which as identified above, is the only defence that could be deployed without *ex-ante* or *ex-post* shareholder approval.

The Company law reform in 2003 unexpectedly repealed article 2364 no. 4 of the Civil Code.[335] The doctrinal debate above is, therefore, of limited importance today.[336] Beyond few specific exceptions provided by the law,[337] there is no general requirement for shareholder authorisation of managerial decisions.[338] Nevertheless, it is usual practice, and viewed by some commentators as a

---

[330] *L'assemblea ordinaria delibera sugli altri oggetti attinenti alla gestione della società [___] sottoposti al suo esame dagli amministratori.*

[331] Only two cases are reported on the issue (both excluding the mandatory scope of the provision): a) Cassazione 7 February 1971, no. 296 *Giust. Civ.* 1972, 869; and b) Cassazione 15 October 1991, no. 10824 *Dir. Fall.* 1992, 766.

[332] See M.S. Spolidoro, 'Tutela dei Soci della Capogruppo di Germania (con uno Sguardo all'Italia)' (1986) *Rivista delle Societa'* 1319.

[333] See V. Calandra, *Buonaura Gestione dell'Impresa e Competenza dell'Assemblea nella Societa' per Azioni* (Milan: Giuffre', 1985), 129 and P. Abbadessa, 'L'Assemblea: Competenza' in G.E. Colombo and G.B. Portale (eds) *Trattato delle Societa' per Azioni* (Torino: Utet, 1993), 20.

[334] Abbadessa, ibid, 27.

[335] As this issue was beyond the scope of the law reform mandate from Parliament. See P. Abbadessa, 'L'Assemblea nella S.p.A.: Competenza e Procedimento nella Legge di Riforma' (2004) *Giurisprudenza Commerciale* 542.

[336] See P. Abbadessa and A. Mirone, 'Le Competenze dell'Assemblea nelle S.p.A.' (2010) *Rivista delle Societa'* 307.

[337] eg the purchase of company's own shares must be authorised by shareholders. Civil Code, art 2357 (2).

[338] ibid, art 2380*bis*.

necessary precondition to satisfying a director's duties of care and loyalty, that when directors take decisions which are of fundamental interest for the company, they should request a non-binding opinion from the shareholders and should subsequently explain the reason for not following such opinion.[339] The effect of this practice and expectation is to impose an advisory shareholder vote requirement where formally available defences are deployed by the board.

4.3 PRACTICAL EFFECTIVENESS

The inquiry above has shown that some board-controlled post-bid defences are theoretically available and consistent with corporate principles of Italian law. The extent of their formal availability is, however, in the absence of shareholder authorisation, limited (if not negligible). Only asset sale defences can be implemented without any shareholder involvement, and if used for defensive purposes a strong case can be made that the board should refer the matter to shareholders for an advisory opinion. There is some scope to use *ex-ante* authorisation to issue shares for defensive purposes. However, Italian law would, in theory, allow shareholders to restrict board authority to issue the shares by placing conditions on any rolling grants of authority if their possible defensive use is perceived to be abusive. Their defensive use would also trigger the advisory vote expectation referred to above.

It may be possible (although, as outlined above, highly contestable and, on the balance of probabilities, unlikely) to put in place a poison pill with *ex ante* shareholder approval. Assuming that the significant difficulties for construction of the pill can be overcome, it is important to ask, as we asked in the context of the United Kingdom, whether such a potentially potent defence could be used to entrench management instead of benefiting the company and the shareholders. For the same reasons we gave in the context of the UK, the answer appears to be no. Under Italian law directors may be removed from office without cause by a resolution passed by a simple majority of the votes cast,[340] and a meeting can be called by shareholders who hold five per cent of the company's issued shares (or the lower percentage provided in the articles).[341] Upon the shareholders' request, directors have to call a meeting 'without delay',[342] and if they fail to do so, the meeting may be called by court order.[343] It follows that directors who keep a pill in

---

[339] See A. Tina, *L'Esonero da Responsabilita' degli Amministratori di S.p.A.* (Milan: Giuffre', 2008), 271 and Libertini, n 324 above, 222.

[340] Civil Code, art 2383 (3).

[341] ibid, art 2367 (1) as recently amended pursuant to Legislative Decree No. 27, art 7 para 1, 27 January 2010 (published in S.O. no 43 of the G.U. no. 53 of 5.3. 2010) implementing Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies. OJ L184/17, 14.07.2007).

[342] Civil Code, art 2367 (1). Directors' discretion for calling the meeting is minimal if the formal requisites are met. See E. Grippo, 'L'assemblea nelle Società per Azioni' in P. Rescigno (ed), *Trattato di Diritto Privato* (Torino: Utet, 1985), 372.

[343] Unless such request is found to be 'unjustified'. Civil Code, art 2367 (2). Needless to mention that it will be very unlikely to be found 'unjustified' a call to decide on the removal of the incumbent directors.

place against the clear wishes of its shareholders are likely to face a proxy fight resulting in capitulation or removal.

This same background rule set is relevant for the directors when considering the consequences of using available defences in opposition to shareholder wishes. In relation to the asset sale defence – the only defence that can be deployed without *ex-ante* or *ex-post* shareholder approval – the practical expectation that an advisory shareholder opinion will be obtained allows the shareholders to make their views very clear. Directors who ignore such views in a hostile context are likely to find their post-bid position somewhat precarious, even in a widely held company. This is a distinguishing feature of the Italian legal framework as compared to the United States, and renders the effectiveness of board-controlled post-bid defences questionable in practice.

4.4 SUMMARY

In conclusion, in our view the background corporate law rule set in Italian law renders the board neutrality changes that have taken place in the past five years of limited import. When analysed through the lens of our three primary takeover defences, the decision whether to have a mandatory or default neutrality principle, and whether to make it opt-in or opt-out is of limited consequence. The most potent of such defences, the poison pill, is in all likelihood not available. No formally available defence can be deployed without shareholder involvement – either *ex-ante* approval or an *ex-post* advisory shareholder opinion. Such authorisation or opinion will invariably require the specification of the defensive purpose of the authorisation. Once made available, the rules on removal rights and the calling of shareholder meetings impose significant informal restraints on how directors use those defences. It is true, however, that in contrast to the UK's improper purpose doctrine or the pre-2001 *Holzmüller* doctrine as applied to takeover defences, there is no overarching rule that would prohibit new and innovative defences without shareholder approval. But as we noted in Section 1, we consider the likelihood of such innovations to be very low. Interestingly, there was such a general rule at the time the Takeover Directive was being finalised, but it unexpectedly disappeared in 2003.

5. CONCLUSION

The analysis set forth in this article suggests that there are two axes upon which we can assess the significance or triviality of the adoption of a board neutrality rule in European Union Member States. The first axis is the extent to which a Member States' adoption of an unqualified board neutrality rule makes a consequential difference to the ability of boards to fashion and deploy defences without

requesting shareholder approval to do so: without a board neutrality rule does corporate law provide the tools to boards to construct defences, and does it allow them to be used without restraint? If one emerges with a positive response from the analysis of these questions, the second axis comes into play, namely, the potency of such available defences. There are two elements that structure defence potency: the first depends upon the nature of the defence itself – an asset sale, for example, is significantly less potent than a poison pill; the second element is the background corporate governance rules such as rules on director removal and the calling of shareholder meetings that enable or restrain the defences' deployment for non-corporate/non-shareholder value purposes.

In all three of our selected jurisdictions we have seen that there are multiple and overlapping fields of regulation. And in each of these jurisdictions there is variation in the importance and effectiveness of these different fields of regulation: variation in what does the work of restricting board defensive power. The rules restricting formal availability are, for example, more important in Germany and Italy – where there are serious doubts about the formal availability of a poison pill or similar mechanism even with *ex-ante* shareholder approval – than in the UK. General rules requiring explicit shareholder authorisation to use board power for defensive purposes are more important in the UK (the improper purpose doctrine) and Germany (the *Holzmüller* doctrine) than in Italy. In the UK and Italy, the background corporate governance rule set is a stronger constraint on the potency of available defences than it is in Germany where supervisory board and management board removal is more difficult. However, whilst there is variation in the role played by these different fields of regulation in each of the three jurisdictions, the conclusions we have reached for the UK, Germany, and Italy are very similar. Although we acknowledge variation in the strength of the argument, the case for the triviality of the board neutrality rule can be made in each country.

In the UK the non-frustration rule is trivial. Only asset sale defences are available without shareholder involvement, and even their use requires specific *ex-ante* or *ex-post* defensive authorisation from the shareholders. Where explicit, authorisation is granted *ex-ante* to construct and deploy defences the background rule set, and the role of UK institutional investors would prevent their use for any purpose that was not compellingly justified in terms of corporate and shareholder betterment. In Germany, poison pills are unavailable, although their functional substitutes may be with explicit shareholder approval and considerable practical difficulty; share issues of greater than 10 per cent of the outstanding shares require, in effect, explicit shareholder authorisation to be used defensively. This leaves less than 10 per cent share issues and share buy-backs with a general *ex-ante* shareholder authorisation (that may always be subject to shareholder imposed conditionality) and only asset sales requiring no authorisation (subject to *Holzmüller*). But asset sales are not potent defences – they are difficult to put in place in the tight time constraints of a bid and may be unavailable if the sold assets are closely interconnected with the remaining assets.

Of our three jurisdictions, Italy arguable presents the weakest case for the triviality thesis. Whilst we think that a strong case can be made that poison pills are not formally available at all in Italy, there is some doubt about this. But even if available they would require *ex-ante* authorisation in order to issue a large grant of warrants. Furthermore, asset sale defences are available without shareholder involvement, and there is scope to issue a sizeable block of shares non pre-emptively to friendly third parties, but again with *ex-ante* shareholder authorisation. Importantly, shareholders unhappy about managerial abuse of defensive capability could put a stop to this by imposing conditions on rolling grants of the authorisation to allot shares. Furthermore, there is under Italian law a soft requirement to obtain the shareholders' view of defensive actions, but this is more of a market practice supported by academic commentary than a legal rule. As in the UK, the background Italian corporate governance rule set is strongly pro-shareholder and would constrain board use of these defences for entrenchment purposes.

What does this mean for the Takeover Directive's approach to its anticipated review of the implementation and effect of the board neutrality rule in the European Union? We cannot, of course, extrapolate from these three Member States to the remaining 24. However, what is clear from this article's findings is that there is a distinct possibility that the board neutrality rule is not merely trivial for the Member States analysed in this paper but trivial for the European Union as a whole. Accordingly, looking only at the adoption or rejection of the board neutrality rule by the Member States does not enable us to draw any conclusions about the extent to which boards of European companies can use defences to entrench themselves or throw sand in the wheels of European economic integration.

What is also clear from this analysis is that corporate law in European Member States provides regulation of takeover defences just as it provides for the regulation of any exercise of corporate power. Such regulation represents a balance of board and shareholder power that has evolved since the 19th century. Such a balance of power readily addresses surprises that may arise from how boards deploy corporate power. A mandatory board neutrality rule cuts through this crafted balance of power and in so doing, as any bright line does, overreaches itself. This is seen most clearly where it prevents informed shareholders from *ex-ante* electing to allow boards to use and control board power for defensive purposes when a hostile bid is made. Approaching 140 years ago in a different context where board loyalty was questioned, a famous English Lord Chancellor, Lord Hatherley, when asked to overrule the election that shareholders had made in the articles, observed that it was not 'for the Court to lay down rules for the guidance of men who are adult, and can manage and deal with their own

interests'.[344] It would, he observed, have been be 'a violent assumption if any thing of that kind were attempted'. We see in Germany, the UK and also in Italy that it is difficult for boards to manoeuvre defensively without explicit shareholder approval, and that the balance of power allows shareholders to respond if managers overstep the mark. And we see from the United States that widely-held shareholders, often led by the bidder as shareholder but also pre-emptively prior to a bid,[345] are not in this context cowered by rational apathy. In European Member States where the situation is similar to Germany, the UK, and Italy it would indeed, therefore, be a 'violent assumption' to assume that a board neutrality rule would be beneficial for companies and shareholders and that it should be imposed through European legislation.

A practical conclusion follows from our analysis. In order to determine whether or not the board neutrality rule is an important regulatory tool that would justify revision of the Directive to make it a mandatory rule within the European Union, the Commission should carry out the type of analysis set forth in this article for all Member States. If the analysis of the corporate law of these Member States suggests that the corporate legal restrictions on defensive action are as significant as they are in the UK, Germany, or Italy, then in our view it would be time for the European Commission to hang up its neutrality boots. There are more important matters that require its attention.

[344] *Imperial Mercantile Credit Association* v *Coleman* (1871) LR Ch. App 558, addressing a provision in the articles of association allowing disclosure to the board of a conflict arising from a self-dealing transaction to render the transaction enforceable and not subject to the common law rules requiring explicit shareholder approval.

[345] See Klausner, n 79 above.