Board of Directors in Hostile Takeover Defence – Towards Managerial Passivity?

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“Corporate mercenaries constantly develop new strategies, both to facilitate takeover attempts and to defend against them”
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European Community Directive 2004/25/EC\(^3\) (Thirteenth Directive, *Takeover Directive*) is a reluctant attempt at building *level playing field* for M&A transactions. A timid effort even to approximate laws on takeover bids and corporate governance. Directive’s general principles – *mandatory bid*, *board’s passivity rule* and *breakthrough rule* – can be transposed into national laws only voluntarily. Unfortunately, without articles 9 and 11 a common European background in mandatory bids, squeeze out and sell out proceedings can hardly be provided\(^4\). On the contrary, implementation of directors’ neutrality rule would have had a profound impact, putting *free cash flow* into effect, emerging simultaneously better market for corporate control and creating more operative internal market.

Nevertheless, pros and cons of directors’ passivity should be conceded. Should directors act as corporate mercenaries during hostile takeover without shareholders’ authorization? Do *anti–frustration rule* foster a mechanism of better assets distribution or is vulnerable to our economy? For whom are corporate managers trustees? For whom indeed should be? Which from the most divergent approaches to takeovers is the most efficient and the most secure? English expressed in *The London City Code on Takeovers and Mergers* or American one created by courts of Delaware and New York State?

The notion whether hostile takeovers can play a key role in corporate governance, bringing recurrent financial market pressures on poorly performing managers, is highly polemical. Thus, boards’ rights in the most significant and divergent legal systems will be analysed. It is significant that Poland has not applied *board’s passivity rule* as seven other European countries and as only one from Central–Eastern Europe\(^5\). Therefore, *de lege ferenda* proposals for Polish *Code of Commercial Companies*\(^6\), *Public Offer Act*\(^7\) and *Takeover Bids Directive* will be outlined.

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White Knights, White Squires and the Pac–Man–
-this is neither a fantasy, nor a fairy story

Pointing out reactive defensive structures, we mean all actions of managers to resist having their firm acquired in hostile way. On the other hand, a friendly takeover is this one where the management board agrees with the takeover and such measures are not used. There are plenty ways to influence the outcome of the hostile takeover bid. They differ, from country to country, depending on market structure and axiology. Whether it is an LME (liberal market economy), which is shareholder–value oriented, or more social CME (coordinated market economy). Thus, map of the comparative political economy is differentiated between shareholder or stakeholder capitalisms. The latter opposing hostile takeovers as a core of market for corporate control, even though evidence proves that after hostile takeovers downsizings do not appear.

However, the conflict between shareholders (principals) and board of directors (agents) is still in existence in corporate structures. Furthermore, there is additional misalignment between directorate and other constituencies (e.g. employees). Thus, to restrain these collisions of interests, system of defensive measures - powerful devices influencing hostile takeovers, should be restructured and its use circumscribed. To analyse whether board's passivity rule should be imposed into Polish and other company laws, reactive defensive measures that board of directors can apply in general, apart from particular legal system, should be examined.

Most known defensive measure, developed in the US, is the shareholder rights plan, which is also called a poison pill. It is a metaphor. If the acquisition of target company is

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9 Reactive defensive measures are applicable after the disclosure of the bid, in contrast to preventive ones which are frequently introduced into the articles of association (C. Podsiadlik, Wrogie przejęcie spółki [Hostile Takeover], Warsaw 2003, p. 59.).
11 Ibidem, p. 11.
triggered, it can make it so expensive that the bidder cannot swallow it\textsuperscript{15}. Even if poison pill is swallowed, it is designed to poison economically an acquirer\textsuperscript{16}. This tactic is based on issuing preferred stock. Management can create a poison pill because authorization of general meeting of shareholders is not generally required\textsuperscript{17}. A triggering event is a nexus of above construction. It occurs when a tender offer is made for a large fraction of the firm, usually 30 per cent, or after a single shareholder accumulated a large block of the firm, usually 20 per cent. The bidder himself can be excluded from exercising his pre-emptive right, which makes a construction of poison pill even more efficient\textsuperscript{18} and more vulnerable for him. It is noticeable, in some normative systems, triggered rights can be redeemed by the board of directors for a short time after the triggering event occurs.

There are many variations of poison pills. Most known are flip–in and flip–over plans. In flip–over pills the exercised rights are used to purchase preferred stock, for, say, $100. The preferred stock is then convertible into stock of $200 equity in the bidding firm in the event of a merger. This is a type of guarantee for shareholders. If they are forced to sell securities in disadvantageous deal, they will have right to buy raider's stock favourably after the merger\textsuperscript{19}. It acts like a repellent. May it be that target firm's shareholders achieve control over raider. The tables can be turned.

In flip–in provisions, the rights are repurchased from the shareholders by the issuing firm at a substantial premium, usually 100 per cent. That is, the preferred stock worth $100 would be repurchased for $200. The triggering firm that made the offer or the triggering large shareholder is excluded from the repurchase. The equity of the bidding firm in the target is automatically diluted. It is worth notice that flip–in pill can give other significant privileges. Most noticeable is the case when the bidder, for example, obtains 30 per cent of securities and each one of shareholders can sell him all his stock. It is especially dangerous for raider, which would acquire only part of securities. Thus, offerer is forced to acquire all the securities. Raider can be, in fact, financially ill-prepared for it. It is worth noting that flip–in pills can include additionally flip–over provisions, which decrease further raider's conditions\textsuperscript{20}. Both

\textsuperscript{15}A. Hanisch, \textit{op. cit.}, p. 12.
\textsuperscript{17}Board of directors acts in this case as a proxy with a prior long-time consent. Though, the obtained power can be abused; R.S. Ruback, \textit{op. cit.}, p. 58.
\textsuperscript{18}A. Hanisch, \textit{op. cit.}, p. 12.
\textsuperscript{20}\textit{Ibidem}, p. 340.
forms of poison pills are severe takeover defences. These plans have the potential to insulate incumbent managers from hostile takeover\textsuperscript{21}. Can market for corporate control tolerate existence of entrenched directorate?

Other main forms of defensive measures are: sale of essential corporate assets (crown jewel defence, also known in extreme as scorched earth approach); acquisitions and divestitures which the raider does not want; the acquisition of the company's own shares from the bidder at a higher price (green mail); as well as bids in turn for the shares of the hostile bidder (Pac-Man defence, counter–tender)\textsuperscript{22}.

Green mail and counter–tender are tactics indeed very expensive. Repurchases can be used as a takeover defence by offering an inducement to bidder to cease the offer and sell its shares back to the issuing firm at a profit\textsuperscript{23}. For example in June 1984 Walt Disney Productions repurchased from Saul Steinberg 12, 2 per cent of its own securities for 325, 3 million USD\textsuperscript{24}. Potential bidder gained 31, 7 million USD. Company, to repurchase its own securities at a higher price, actually, has to contract a loan. It can be harmful to corporate financial liquidity and it is noticeable that directors' vulnerability should be restrained.

Counter–tender (Pac-man defence) is a tactic a little bit different from green mail, because is used to fend off the attack by firm, which just is being acquired\textsuperscript{25}. Company that is threatened with a hostile takeover turns the tables by attempting to acquire its would-be buyer. Example from U.S. corporate history is the attempted hostile takeover of Martin Marietta by Bendix Corporation in 1982. In response, Martin Marietta started buying Bendix stock with the aim of assuming control over the company. Bendix persuaded Allied Corporation to act as a white knight, and the company was sold to Allied the same year. The incident was labelled a Pac-Man defence in retrospect\textsuperscript{26}. But there is broad evidence that Pac-man is harmful both to the bidder and to the firm which is being acquired. In case taken above, Bendix has become eliminated from the market as independent entity. Furthermore, Martin Marietta was subjected, not to the first bidder, but to the ally\textsuperscript{27}. Thus, Pac-man is a double–edged sword and hereinafter abilities of the board should be conceded.

Target company often looks for alternative bidder. In business jargon, he is called a white knight. It may be a private company, or a person that intends to help another firm. The

\textsuperscript{21}R.S. Ruback, op. cit., p. 60.  
\textsuperscript{22}A. Hanisch, op. cit., p. 12.  
\textsuperscript{23}R.S. Ruback, op. cit., p. 61.  
\textsuperscript{24}A. Sobol, op. cit., p. 342.  
\textsuperscript{25}Ibidem, p. 341.  
\textsuperscript{26}Ibidem.  
\textsuperscript{27}Ibidem, p. 340.
role of a white knight is to raise price of the bid\textsuperscript{28}. He can change the process of hostile takeover into an auction and mobilise in this way raider to revise a share price upwards. In such conditions target firm's board can choose the offer. Such movement is one of scarce number of defensive structures where managerial board cannot hinder the offer, which would have decreased wealth for shareholders.

In hostile takeover defence directors often propose changes in acts of association, making target less attractive for bidders. Such amendments, called shark repellents, can only be introduced by general meeting of shareholders. However, introduction is dubious when raider is just to acquire huge number of securities. According to, for example, French Code de Commerce, shark repellents cannot be introduced after the disclosure of the takeover offer\textsuperscript{29}.

Directors can achieve a dual class recapitalization as well. Company distributes a new class of equity with super voting rights and inferior dividends or marketability to stockholders, allowing them at the same time to exchange the new shares for ordinary common stock. In this way, creating securities of different rights, the management can obtain voting majority without majority in common stock\textsuperscript{30}. It gives managers a veto right over changes in control. Even if a bidder were successful in acquiring all of the outside equity, it would neither have sufficient votes to replace the present directors nor to merge with the target.

Staggered board elections can be proposed. In this provision, the board is differentiated into, for example, three groups. In each year, only, say, one–thirds of directors are replaced. It makes very difficult for a bidder to obtain control over the target company immediately, though raider has majority in common stock. This limitation may in turn reduce the bidder’s willingness to bid, and may make target firm's restructuring a tough attempt.

Super – majority provisions can be brought in. Thence, hostile takeover bidders require a higher percentage of shares to obtain control over the target firm after such amendment, for example 80 per cent.

Directors can contract with a company a standstill agreement. This agreement limits the ownership. Settlement may cover allotment of a number of seats on the board for a specified time (standstill time). Such agreement serves as a takeover defence because can exclude, at least temporarily, a potential bidder. The incumbent major shareholder may gain some control over corporate assets through seats on the board. In fact, a standstill agreement

\textsuperscript{28}Ibidem.
\textsuperscript{29}C. Podsiadlik, \textit{op. cit.}, p. 64.
\textsuperscript{30}R.S. Ruback, \textit{op. cit.}, p. 55.
is for many more like a treaty than a defence\textsuperscript{31} and it is presumably not so harmful like for example a \textit{poison pill}. Prior authorization is required, so the directors' bias is restrained. Furthermore, board’s discretion is enlarged only for specified time \textit{e.g.} time in which firm is being taken over.

A kind of \textit{financial announcement} (or, speaking more vividly, \textit{financial response}) can be made. Target's board discloses new financial information, including better income\textsuperscript{32}. This way, company incurs liability to increase income. If liability is breached, high dividends for shareholders will be paid. Such act additionally proves good condition of corporation. In 1989, in this manner, \textit{Bat Industries} resisted the hostile tender offer of British–American corporation \textit{Hoylake}. \textit{Bat} had announced profit enlargement in few months' time. Furthermore, claimed that offered price is inadequate. Indeed, \textit{Bat} achieved the financial aim. Therefore, suddenly \textit{target} was restructured. Two subdivisions had stood out, and then each one was turned into subsidiary company\textsuperscript{33}. \textit{Hoylake} failed.

Lastly, board of directors can bring suit to bidder company, charging the \textit{raider} with fraud or violation of securities or antitrust regulations \textit{etc.}

Severe defences give the incumbent managers absolute \textit{veto} power over changes in corporate control\textsuperscript{34}. There is indeed a broad agreement that being a tender offer target essentially increases shareholders' wealth\textsuperscript{35}. American historical assessment points out prices of target firms’ shares increase approximately 30 per cent in tender offers\textsuperscript{36}. Thus, system of takeover procedures has to be constructed to block inefficient and hazardous moves (from shareholders' and corporate point of view) and to make a profit for owners\textsuperscript{37}. Insulation of company, especially entrenchment of directors, makes a firm more difficult to acquire. The more insulation of company, the less probability of premiums for shareholders. Some of

\textsuperscript{31}Ibidem, p. 63.
\textsuperscript{32}A. Sobol, \textit{op. cit.}, p. 339.
\textsuperscript{33}Ibidem, p. 339.
\textsuperscript{34}R.S. Ruback, \textit{op. cit.}, p. 56.
\textsuperscript{35}Ibidem, p. 49.
\textsuperscript{36}Ibidem, p. 49.
\textsuperscript{37}In many legal systems board of directors should act in interest of corporation as a whole (General Principle 3 of \textit{The London Code On Takeovers And Mergers}, Article 368 para 1 of \textit{C.C.C.}, Article 3 para 1 point c of \textit{Takeover Directive}). But in the first and in the latter regulation it is stated that board of directors must not deny the holders of securities the opportunity to decide on the merits of the bid. It is obvious that in company the profit of shareholders is the easiest to measure. Thus, to facilitate reasoning, the position of the board will be assessed from shareholders' wealth priority. Deep analysis of other constituencies’ interests is beyond the thought of article.
above provisions are applicable at the board’s discretion, when directors oppose to takeover\textsuperscript{38}. In this way, board of directors can get rid of shareholders' control\textsuperscript{39}.

There are defensive structures which can increase the price of securities like looking for \textit{white knights} or \textit{white squires}. Nevertheless, there are truly a great spectre of dangerous defensive measures to, both, corporate interest and shareholders’ benefit. Sometimes directors use extreme anti-takeover defences to prevent a hostile tender offer. Such power can result in negative outcome for shareholders. Directors claim that without the board as a centralized bargaining agent, shareholders will sell out at too low price. Such a view is casual and incorrect by perceiving market for corporate control as uncompetitive and inefficient. Furthermore, extreme forms of takeover defences can have severe effects because the removal of inefficient managers is prevented\textsuperscript{40}. The role of legislator is to provide system of neither complete company's neutralisation, nor absolute managerial activity, but of tempered directorate’s performance. It means management would have triggered most of defensive measures only with general meeting of shareholders’ authorization, and would have played as auctioneer without it.

\textit{Principal – agent conflict}

Hostile takeovers boost up the economy like an effective deterrent, eliminating inefficient members of targets’ boards\textsuperscript{41}. Most commentators have concluded that the possibility of takeover is generally beneficial for the market. This is playing an important role in helping the economy adjust to major changes in competition, imposing restructure moves on ineffective companies. This phenomenon is a main core of healthy market for corporate control. By loosening control over vast amounts of resources, enables them to move quickly to their highest–valued use. Takeovers generally occur because changes in technology or in market conditions require reform of corporate assets. They provides at least four benefits for shareholders and the market in general: better allocation of resources, synergy gains, better management, more accurate market valuation and - the most remarkable issue – better

\textsuperscript{38}R.S. Ruback, \textit{op. cit.}, p. 57.
\textsuperscript{39}Defensive measures where prior consent of general meeting of shareholders is required, like \textit{staggered board elections}, \textit{super–majority provisions}, \textit{dual–class recapitalization}, \textit{shark repellents}, will not being further analysed. The problem whether competencies of general meeting should be circumscribed in hostile takeover is merely touched on. Work is concentrated on protective acts which relied mainly in directors’ discretion.
\textsuperscript{40}R.S. Ruback, \textit{op. cit.}, p. 52.
management discipline. New management with no ties with current employees and communities can make fundamental changes\textsuperscript{42}. It is worth notice that acquisition after takeover of target's securities is cheaper and more reasonable than bankruptcy, usage of insolvency proceedings or \textit{status quo} with market overcapacity.

The most effective incentive for directors is sole danger of being taken over in hostile way\textsuperscript{43}. Board of directors is in natural misalignment with shareholders and stakeholders (\textit{principal–agent conflict})\textsuperscript{44}, even though, managers are shareholders’ agents. Both parties are self-interested and this is a cause of serious conflict among them about corporate strategy\textsuperscript{45}. It is noticeable that whereas owners desire to have profits dispersed to them through the issuance of dividends, directors and officers prefer to have the profits reinvested in the company and preferably trickled down into salaries\textsuperscript{46}. If managers are ineffective, acquisition can eliminate the expenditures on internal investments with negative market value. Some of the gains are transferred to the target firm's shareholders. \textit{Free cash flow} is only one of many factors that go into takeover decision. However, the evidence indicates that it is an important one in providing a useful perspective on the conflict. It shows that hostile takeover can ditch inefficient management, clearing channels of cash flow.

Managers with large stockholdings in their firms are less likely to oppose takeovers than manager with small stockholdings\textsuperscript{47}. This is based on the presumption that people act to enhance, as A. \textit{Smith} noticed, their individual benefits, which often differ from each other\textsuperscript{48}. Managers with small stockholdings oppose too much, because they care about their jobs and have no equity gains to offset the loss\textsuperscript{49}. Therefore, the incentivisation must be built into legal system. Thus, the threat of takeover can discipline the management of a potential target corporation to improve its performance. If management knows that it will lose the job in the event of takeover, it will work to make sure that such takeover is unnecessary. Inefficiencies will be reduced. Increase of share price lower the possibility of being taken over\textsuperscript{50}. The

\textsuperscript{42}M.C. Jensen, \textit{op. cit.}, p. 23.
\textsuperscript{45}M.C. Jensen, \textit{op. cit.}, p. 28.
\textsuperscript{47}R.S. Ruback, \textit{op. cit.}, p. 53.
\textsuperscript{49}A. Hanisch, \textit{op. cit.}, p. 53.
\textsuperscript{50}W. Magnuson, \textit{op. cit.}, p. 209.
potential of being acquired is a constant reminder to management that it must perform its duties with utmost care. Weak participants of the market are likely to be replaced. And this occurs immediately if directors do not lead their company in an efficient way.51

It has to be taken into account that directors have the greater power, the more dispersed shareholders are. Because of dispersion, they cannot exert influence on the board. Therefore, directors can abuse their power. Small shareholders are not able to control management – it is too expensive. None of shareholders supervises the board, because if one does, others effortlessly take profit from his work. Here, so-called free rider problem has appeared. None of shareholders covers the total cost of supervision. It would be irrational. Many of small stockholders even do not use their vote owing to disproportionately high effort of participation in general shareholders’ meeting to power of vote (rational apathy of dispersed shareholders). More rationally is to observe share prices at stock exchange and sell them when the price is falling down. Seemingly, the best move to protect dispersed shareholders is to change the construction of company (Unternehmenverfassung), imposing board's neutrality rule. If board is not under control of owners, only market forces can discharge the supervision. Hostile takeovers are economically rational and should not be blocked by management. If not, external corporate control would be crashed.

Thirteenth Directive – the washed–up chance

Nonetheless, members of the board of directors, scared of being fired, coax shareholders into using defensive measures.54 In American model they can conduct such measures on they own, obeying business judgement rule and loyalty rule, acting bona fide. Directive 2004/25/EC in Article 9 (derived from Code on Takeovers and Mergers) proves that American and European takeover regimes remain in extreme divergence.

Takeover Directive, though the protectionist transposition, tries to develop free cash flow by making general shareholders meeting an only authority in triggering defensive measures, except management’s decisions in ordinary course of business.55 For this reason, this principle is often called anti–frustration rule, neutrality or passivity rule. Article 9 of Takeover Directive is a solution extracted from one of the most developed regulation –

51A. Hanisch, op. cit., p. 25.
52R. Stroiński, op. cit., p. 5.
53Ibidem.
54L. Czerwonka, op. cit., p. 106.
55M. Menjucq, op. cit., p. 228.
General Principle 7 and Rule 21 of *The City Code on Takeovers and Mergers*. There board of directors is deprived from using any actions to hinder the offer just from the time when the board has reason to believe that it is imminent\(^{56}\). Such actions are: issue of actions, disposition of assets of material amount, entering into contracts beyond the ordinary course of business, purchase of company's own actions (Rule 21 and 37.3 of *The City Code on Takeovers and Mergers*). In comparison, *Takeover Directive* is a little bit less radical. It is forbidden to frustrate the bid before the general meeting of shareholders has reached decision on it. Article 9 provides that the *anti-frustration rule* has an effect from the beginning of the bid (\(i.e.\) at least from the time the board of the offeree company receives the information concerning the bid and until the result of the bid is made public or the bid lapses\(^{57}\)). Article 9 has been created to fight natural bias of directors. Effectively, there is potential conflict of interests because the success of the bid can have consequences on management, which can be supplanted by the new one, pursuing another strategy. Thus, to avoid directors' entrenchment, it is better not to give the management the power to frustrate the bid without agreement of the general meeting of shareholders. Furthermore, directors should be deprived of this sphere of decision-making power like applicability of defensive measures\(^{58}\). Presumably, only authorised actions of directors during hostile takeover attempt do not play any role in its personal interests\(^{59}\). From the economic point of view it is better to restrain board's discretion to perish hostile tender offer, because the probability of being acquired would incite the managers to improve the quality of management. Perhaps, the best defence against potential takeover bid is improvement of the management and growth of the price of a listed company's shares. Additionally, Article 9 is strengthened by Article 3 (c), which states: *board of an offeree company must act in the interest of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid*\(^{60}\).


\(^{57}\)M. Menjucq, *op. cit.*, p. 229.


\(^{59}\)A. Hanisch, *op cit.*, p. 17.

\(^{60}\)Directive 2004/25/EC, Art. 3 (c).
Despite of such principles, directive is a good document, but only for scientists. It can be described as the source of law not worth the paper it is written on. Either countries or companies can decide not to apply anti-frustration rule. Thus, if the rule is not applied, directors can take all the measures related to its competence. Board is able to frustrate the bid or can apply measures delegated thereto by the general meeting of shareholders – assuming those delegations were allowed at least 18 months before a bid.

Turning Article 9 into an obligatory one is an only way to resolve the problem by creating new European corporate governance rules and realising the idea of internal market. Sufficient protection is already created in Article 12 (5) (exempt companies which apply Article 9 (2) and (3) and/or Article 11 from applying those Articles if they become the subject of an offer launched by a company which does not apply the same Articles as they do, or by a company controlled, directly or indirectly by the latter). It develops insulation e.g. for European companies which would have been otherwise acquired by American corporations with more powerful boards of directors. In such condition management of target company will be able to frustrate the tender offer. Such action, of course, should be conducted inter alia in good faith. After imposition of described amendment Europe can make up for the lost time.

**American Takeover Regime, directors' activity**

**and the Jonestown defence**

To consider whether the passivity rule should be applied into Polish system, we have to skim trough rules of American takeover regime. The latter is divergent from European model. American and European laws regulating hostile takeovers, one of the most remarkable events in corporation's life, have remained strikingly dissimilar. It has not been yet explained why the divergence in this area of law has resisted, and indeed increased in the face of broader trends favouring assimilation.

The United States and European Union have adopted drastically different solutions in M&A law. The United States has given a vast amount of freedom both to

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64 Implementation of Article 9 is not obligatory. Although it is worth to underline that in many countries directors'
acquiring and target company. The acquiring company can make an offer for any number of shares, and the target board of directors may take defensive measures against acquirer. On the other hand, in the European Union both the acquirer and the target are under restrictions. Offer for example must make a bid for all outstanding shares and the target board of directors cannot take any actions until shareholders have authorised them. American law is more flexible. A common defensive tactic in the United States is for a target corporation to buyback its own shares. In most European countries, in accordance with the second directive on company law, purchasing firm’s own shares is subject to more strict regulation (for instance, only up to 10 per cent of the outstanding shares can be bought). Obviously, the transaction has to be authorized at shareholders’ meeting. Thus, in United States generally, directors sustain extensive powers to amend bylaws. It is natural for American directors to trigger frustrating actions. In comparison, in civil law systems, powers are usually vested with the shareholders’ meeting. This facilitates takeovers, while at the same time gives greater protection to shareholders from the misaligned interests of directors.

Whether American board of directors can thwart a tender offer is assessed under Unocal/Revlon Duties. Under Unocal (Unocal Corp. v. Mesa Petroleum) court examines whether the transactions at issue is defensive (from company's point of view). The Delaware Supreme Court recognized that in takeover situations directors are of necessity confronted with the conflict of interest. Acquirer is indeed likely to replace the board. Thus, court established two-tier assessment to determine whether directors could implement defensive measures against hostile takeover. First, the directors must have reasonable grounds to believe that the takeover presents danger to corporate policy and efficacy of company. Secondly, such measures must be reasonable in relation to the thread posed (Unocal Duty). Additionally, in Dynamics Corporation of America v CTS Corporation court alleged that defensive structures can be used only if offer share price is inadequate. Ipso facto court restrained actions which are negative and vulnerable to shareholders and company.

passivity rule is existing certainly (e.g. United Kingdom, Italy, France, Germany) and can be in the future a guideline of European Takeover Law.

65W. Magnuson, op. cit., p. 206.
66Ibidem, p. 207.
68Ibidem, p. 183.
70493 A.2d at p. 955.
71W. Magnuson, op. cit., p. 215.
excluding such extremes as *Jonestown defence* (auto-destruction of company) or *scorched earth approach*.

In *Omnicare, Inc. v. NCS Healthcare, Inc.* the Delaware Supreme, in a split decision, held that the court must first determine whether the defensive measures, which protected company against merger, are not *preclusive* or *coercive*. **Only if they are found not to be preclusive or coercive, should the court apply the proportionality test of Unocal***72***.

The directors prove reasonable foundations by showing *good faith* and reasonable investigation. The court did not require shareholders' approval before directors could take defensive measures. Freedom of directors is circumscribed by *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.* If takeover is inevitable, once as sale is in progress, the directors’ duties switches from protection or maintenance of the corporation as an entity into *obtaining the highest price for the benefit of the stockholders***73***. Thus, managers from defenders are turning into auctioneers. In a different way board's actions could be perceived as *coercive, presumptive, or draconian* (as has been described in *Unitrin, Inc. v. American General Corp.*) and thereby automatically inappropriate.

The series of Delaware Court cases restrain board of directors' discretion in takeover defence. However, management in the United States has wide capacity to resist potential hostile takeover as long as they act *bona fide* after reasonable investigation, and as long as the measures adopted are not *draconian* and *exclusive***74***. The doctrine applied complex standard of *business judgement rule* and the *intrinsic fairness test* (estimating whether the breach of loyalty to shareholders exists). It proves that States empowered boards to protect companies, taking into account a broad range of factors in decision–making process.

**Grossman – Hart equation**

Defensive measures that can decrease the share price, need to be authorized by general shareholders' meeting. The economic efficacy of *board's passivity* is described both by operation presented by *Richard S. Ruback* and *Grossman – Hart equation***75***.

\[ \text{'Market value of the firm} = \text{Value of the firm with current managers} + \text{Probability of a control change} \times \frac{\text{Change in a value from a control change}}{} \]

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**Notes:**

73506 A.2d 173 (Del. 1985).
74W. Magnuson, *op. cit.*, p. 216.
Shareholders are concerned about how takeover defences affected all three components of company's value: **the value of the firm under incumbent management, the likelihood of an acquisition, and finally offer price when takeover bid occurs.** While takeover defences may lower the probability of being acquired, they can also increase the tender offer price. Therefore we have to balance, defensive tactics and, on the other hand, enactments to boost up a price. Consideration of a defence that allows incumbent managers to completely block all takeover bids, shows that reduction of a *control change* to zero, eliminates evidently takeover premium\(^{77}\). It is known undoubtedly that takeover bid could stimulate managers to stop wasting time and corporate resources worrying about a hostile takeover. Hence, directors should be turned into auctioneers. Board of directors should have played as group of defenders (or, more vividly speaking, *corporate mercenaries*), only ultimately, if takeover could perish the firm as an entity or when could be vulnerable to its interests and policy.


We assume that the profit of typical firm is given by a function \(f(a)\)\(^{78}\), where \(a\) is a description of activity engaged in by the firm (*e.g.* investment decision, management efforts). \(F(a)\) can be interpreted as the net present value of the future stream of profit generated by \(a\) enactment. \(A\) denotes the set of all feasible activities of the firm. Thence we have to imagine a firm using activity \(a_0 \in A\). \(q = f(a_0)\) denotes the current profit of company.

*Raider* announces a tender offer with price \(p\). He is willing to buy all shares tendered to him. Analysing the process of taking target firm over, *raider* can be assumed as a *profit maximizer*. Thus, \(\max_{a \in A} f(a)\) is a maximum profit under incumbent managers. New management boost up the profit to \(v = \max_{a \in A} f(a) + \varepsilon\). \(\varepsilon\) denotes the difference in ability between the *raider's* and *status quo ante quem* management. \(\varepsilon\) and \(v\) are random variables. Both, the *raiders* and shareholders know approximate \(\max_{a \in A} f(a)\) and \(v\) at the time of the raid.

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\(^{76}\)Ibidem, p. 50.

\(^{77}\)Ibidem.

Takeover bid will be deemed successful if the raider will acquire more than 50 percent of shares. Anyone of shareholders, who think that the raid succeed with certainty, tender his shares if \( p < v \). It is indeed necessary that only \( p \geq v \) gives shareholders the anticipation that the raid will be succeeded. Unfortunately under these conditions raider makes no profit. In fact, raids are costly; the raider actually makes a loss!

Raids are unprofitable because each shareholder is in a position of free ride on a potentially successful bid. He can probably gain more if remain an owner of company. Indeed, any profit that raider can expect from the share price appreciation can be captured by free riding shareholder, if a company will not be acquired. In American takeover system costs of takeover are higher than in Europe. It is because frustration actions can be fostered without shareholders’ agreement. Many frustrations can be equivalent to elimination of market for corporate control forces – restructure, better allocation of assets. May it be one factor among many, which causes characteristic short-term wrenches to American economy?

Despite of problems noticed above, market myopia\(^79\) is an engine of hostile takeovers. Raider’s and shareholder’s valuation of the firm is different, due to variant risk preferences and informational asymmetry.

Thus, relying upon Grossman-Hart equation, shareholders’ valuation will be \( v_s \), different from \( v \). \( c \) denotes the cost of the raid. The raider's profit is then:

\[
\pi = v - v_s - c^{80}
\]

If \( v_s \) is sufficiently small to \( v \), raid will occur. According to Hart and Grossman, it is desirable, except that managers should be deprived from ability to foster defensive measures without authorization, to write down in company's constitution some additional privileges for dominant shareholder – \( \varphi \) (dilution factor)\(^81\). It makes takeover more possible. Dilution factor lower the costs of takeover. Then, tender offer price will be:

\[
p = \max (v - \varphi, q)^{82}
\]

If \( c \) denotes the cost of the raid, the raider’s profit will be:

\(^{79}\)M.C. Jensen, op. cit., p. 25 et seq.
\(^{80}\)S.J. Grossman, O.D. Hart, op. cit., s. 46.
\(^{81}\)L. Czerwonka, op. cit., p. 25 et seq.
\(^{82}\)S.J. Grossman, O.D. Hart, op. cit., s. 47.
\[ v - p - c = v - \max (v - \varphi, q) - c = \min (\varphi, v - q) - c^{83} \]

The aim of dilution factor is not to facilitate takeovers per se, but to create strong incentive for board of directors. A company is likely to become a target if its share price falls under potential value of the firm. Thus, if management would keep firm away from probability of being taken over, they should sustain company's value at \( q > v - c^{84} \). In this way deterrent works. On the contrary, directors' entrenchment can perish company's financial liquidity. Therefore, Grossman – Hart equation proves that hostile takeovers serve as basis of external corporate control, by being a deterrent for directors.

Furthermore, the evidence proves that indices of taken over companies increase faster than indices of defended ones\(^8\). Simultaneously, it is significant that offer premium is higher if target company uses defensive measures. However, such measures cannot be coercive. Contrarily, offer will collapse. It suggests that directors should act as auctioneers, and not as defenders without authorization. Beyond breaking point offer fails and company's and shareholders' premium will never be available.

Hart – Grossman equation proves that too strong defensive measures diminish market for corporate control. In such conditions, managers achieve their aims instead of maximizing the value of the firm. On the other hand, facilitation of hostile takeovers disciplines directors and creates more efficient external economic control\(^8\). Hostile takeovers build foundation of market for corporate control as they constitute a means to transfer control over unsuccessful companies to new shareholders, enabling efficient management and increase of company assets to a higher value. Company's and directors insulation is harmful for shareholders, because the governing process remains in ineffective status quo. Taking above into account, directors' passivity rule should be turned into an obligatory principle of emerging level playing field and European internal market and, moreover, should constitute a basement for new pan-European corporate governance rules. Neutralization of the board during hostile takeover offer can soften conflicting interests in company and, simultaneously, upsets in the market could be avoided. Furthermore, passivity rule can protect shareholders,

\(^{83}\) S.J. Grossman, O.D. Hart, op. cit., p. 47.
\(^{84}\) L. Czerwonka, op. cit., p. 111.
\(^{85}\) M. Łakomy, Obrona spółek przed wrogim przejęciem w czasie V fali [Hostile Takeover Defence during the Fifth Wave Period], Myśl Ekonomiczna i Prawna [Legal and Economic Thought] 2006, No. 3, p. 46 et seq.: Author took into account 17 attempts of hostile takeovers from 1999 up to 2005 worldwide.
\(^{86}\) Ibidem, p. 111.
by distributing the majority “prize” to all of them and enabling the transfer of control over listed companies. This is a value in itself.

**Proposals de lege ferenda of Polish company law reform**

Unfortunately, in Polish company law a wide lacuna in defining precisely whether or not the board of directors can frustrate the hostile takeover bid is still in existence. Polish company law should impose directors' passivity rule as soon as possible. Otherwise, issues of frustrated hostile takeover bids will have to be assessed in expensive litigations that will hit the company’s bottom line. Board of directors should be deprived of using so-called show stoppers. The managerial board has an incentive to fight off even value-maximizing takeover. Otherwise, if the offer is successful, directors are likely to lose their jobs. Takeover regulations are designed to maximize shareholder value by encouraging beneficial takeovers, while minimising the risks of directors' misbehaviour.

Polish Public Offer Act, as previous statute – Securities Exchange Act, contains several directors’ duties. Article 80 para 2 of Public Offer Act is the equivalent of Article 9 para 5 of Takeover Directive. Board of directors can be biased, therefore is obligated to present his opinion on takeover bid. Aim of above information is to reduce market myopia and shareholders' lack of information. This statement should assess the influence of the takeover on the company, its employment, include a description of strategic plans of the offerer and evaluate the offer share price (is it equitable or not). It restrains somewhat directors' ability

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89 Supra, note 5.
91 The board of the offeree company shall draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business as set out in the offer document in accordance with Article 6(3)(i). The board of the offeree company shall at the same time communicate that opinion to the representatives of its employees or, where there are no such representatives, to the employees themselves. Where the board of the offeree company receives in good time a separate opinion from the representatives of its employees on the effects of the bid on employment, that opinion shall be appended to the document.
to frustrate the bid, enabling informed shareholders to oppose the board. However, regulation seems to be ineffective, if stockholders are widely dispersed. Coincidently, under Article 80, it is hard to say whether directors can frustrate a tender offer. There are a few voices claiming that the discretion of board of directors in Polish law is as wide as in American takeover regime. So, what powers in fact board of directors has? What amendments should be introduced to avoid misuses?

Board of directors cannot conduct actions against corporation and its shareholders. Nonetheless, Polish regulation is highly imprecise. Under Article 80a para 1 of the Public Offer Act, frustration bids are not excluded. Wide lacuna in Polish takeover regime can result in expensive and lengthy litigations. Article 368 para 1 of C.C.C. is unable to fill it. The statutory provision “to conduct the issues of the company” is not synonymous with “to act within ordinary company's course”. The discretion of directors is merely restrained by abilities of general shareholders' meeting. Nevertheless, current Polish company law does not state clearly whether directors should play passively in hostile takeover defence.

It appears that under Polish takeover regime board of directors can use most of defensive structures. Directorate can primarily foster a poison pill which can be applicable under Article 444 of C.C.C. An institution of increase of authorized share capital enables company to make money in the stock market (Under the statutes, the management board can be authorised, for a period no longer than three years, to increase the share capital [up to 3/4 of the stock]). It makes company more flexible and adaptable to market changes. Nonetheless, under such regulation board of directors, through prior authorisation, can obtain a wide discretion which can be used to frustrate the offer. Emancipated board can deprive shareholders of their right to decide in the particular case. It is worth notice that competencies of directors are circumscribed by Article 447 of C.C.C. Board of directors cannot exercise on its own a power of deprivation of pre-emptive rights (Article 444 para 7 of C.C.C.). Even if directors are authorized under the statute to deprive the shareholders of their pre-emptive rights, entirely or in part, the consent of supervisory board is required. Thus, additional buffer

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93 Ibidem.
94 Cf. K. Oplustil, ibidem, p. 5; Argumentum ex Article 80a para 1.
95 Cf. ibidem, p. 4.
96 For other opinion, see supra note.
97 See C.C.C., Articles 228 to 230.
98 K. Oplustil, Obrona... (cz. II), p. 4.
101 Authorization has to precise the amount of capital increase, otherwise is invalid.
was made. Board of directors cannot be entitled to increase the share capital from company’s own funds (Article 444 para 5 of C.C.C.). This way, boards of companies created under Polish law are fairly restrained. Nonetheless, poison pill per se (not even flip – in or flip – over provision which cannot be used by directors of Polish companies\textsuperscript{102}) is very hazardous. It can simply hinder the offer. Furthermore, it is more hazardous when board of directors has an authorization (with consent of supervisory board\textsuperscript{103}) to deprive shareholders of their pre-emptive rights. Under above provisions, poison pill à la polonaise can be created and board of directors can under article 432 para 2 precise unlimited period of deprivation that covering time prior to the moment when decision is made\textsuperscript{104}.

So, in this case, model solution can be found in French Code de Commerce, where prior authorisations in period while firm is being taken over are switched off, despite of these measures accepted in response to particular takeover\textsuperscript{105}. Such regulation seems to be reasonable, enabling the directors to make money in the stock market, simultaneously eliminating the vulnerability to shareholders.

Under Article 362 para 1 (points 1 and 2) board of directors can purchase company's own shares up to 10 per cent of the stock to: prevent serious damages which would appear if firm was acquired; offer shares to company's workers\textsuperscript{106}. Obviously, self-acquisition of shares reduces their liquidity. Furthermore, decline in supply and increase in demand has simultaneous effect on share price. Therefore, when the price became unattractive, the bid can easily collapse\textsuperscript{107}. Buyback of company's own shares, even if regulation is violated, is further valid. Shares should be sold in one-year term; otherwise will be terminated. Even though, the supply of shares is shortened. There is only a small possibility to penalise for breach of Article 362. It is very hard to prove that buyback was conducted against real interest of the company. It should be proved that purchase of firm's own shares was done with intentional guilt. Polish

\textsuperscript{102}C.C.C., Article 444 para 5.
\textsuperscript{103}Despite of applied buffer in form of supervisory board’s consent, the conflict between managerial board and shareholders still exists. National company laws within European Union use two mechanisms of governance: one–tier system with administration board (in United Kingdom) and two–tier system with board of directors and supervisory board (in Poland and Germany). Even though, management structure is divided into two tiers, the principal – agent conflict still remains. Requirement of the supervisory board’s consent is not a sufficient protection of shareholders’ rights. If a hostile takeover came into effect, board’s members will also be replaced.\textsuperscript{104}C. Podsiadlik, op. cit., p. 328.
\textsuperscript{106}Sum of all shares from all sources cannot exceed 20 percent of the stock (362 para 2 point 2 of C.C.C.); see M. Ventoruzzo, op. cit., p. 183 et seq.
\textsuperscript{107}K. Oplustíl, Obrona... (cz. I), op. cit., p. 3.
regulation seems unable to eliminate abuses, such as greenmail defence\textsuperscript{108}. Therefore, the requirement of prior buyback authorization should be introduced and purchase without it should be \textit{ab initio} invalid.

\textit{Crown jewel defence} in Polish takeover law is, unfortunately, also applicable. Power of the board is delimited by the discretion of the general shareholders' meeting. Accordingly, under Article 393 point 3 and 4 of \textit{C.C.C.} board of directors cannot, without authorization, sell immovable properties and enterprises. But the other jewels can be sold.

Other defensive structures cannot be excluded from the directors' power. \textit{Ipso facto Pac – man} can be used. In cooperation with supervisory board \textit{golden parachutes} for directors can be prepared.

Defensive measures can reduce shareholders' wealth. Thus, role of new corporate governance rules is to create efficient market for corporate control, especially to protect diffuse shareholders. Ambiguities in company law can perish it. Hence the need for implementation of, not only directors' passivity rule, but neutrality of supervisory council during takeover offer period as well, into Polish law. Supervisory board is also in misalignment with shareholders' meeting. Frequently, when company is taken over, members of supervisory council are changed. Ban on the defensive measures should be applied, not only from the moment when the offer is notified, but just when the tender offer is imminent. Otherwise, the prohibition specified in Article 9 (1) of \textit{Takeover Directive} might be fostered too late to provide effective protection to shareholders’ interests\textsuperscript{109}. However, board should have ability to search for \textit{white knights} whom can increase stockholders' wealth. Such provisions can make management more disciplined\textsuperscript{110}. Thence, only the following measures should be permitted, contrary to the general passivity rule. Thus, management in the future should be able only to:

- take measures authorised by the shareholders after the disclosure of the bid,
- continue ordinary course of business (e.g. \textit{Pac – man defence} should be banned),
- continue the measures outside the ordinary course of business with authorisation prior to the disclosure of hostile bid,

\textsuperscript{108}C. Podsiadlik, \textit{op. cit.}, p. 174.
\textsuperscript{109}N. Moloney, \textit{op. cit.}, p. 829.
\textsuperscript{110}\textit{Ibidem}, p. 5.
- search for competing offers\textsuperscript{111}.

Coincidently, if foreign raider (or his parent company) has not applied the rule, anti–frustration rule should be turned off (reciprocity rule). Furthermore, according to Rule 21 of British City Code on Takeovers and Mergers, it is preferable to create non–exhausted list of directors' banned deeds (e.g. issue of securities within the spectre of enlarged target, shares buyback, incurrence of obligations beyond ordinary course of business and with aim to decrease value of the target firm, Pac–man defence)\textsuperscript{112}. Nonetheless, hostile tender offer can be vulnerable to shareholders' interests and company's policy. Thus, amendments to C.C.C. to develop defence against sudden attack should be created. For this reason, extraordinary meeting of shareholders should be convoked within shorter period than currently (for example 7 days as an exception to Article 402 para 1 of C.C.C.) to authorise defensive measures.

According to Rule 25 of London City Code On Takeovers and Mergers it is suggested to oblige board's members to disclose all the connections with the bidder. It should make directors' deeds more transparent and can limit excesses of competence and malpractices.

Taking into account a fundamental misalignment between the interests of directors and shareholders, lacuna in Polish company law should not be filled by creating American–like model of board activity. Many of Polish legal scholars are convinced that Polish model of board’s activity is close to American one\textsuperscript{113}. This model, however, seems inappropriate for Poland. Board of directors cannot conduct actions against corporation and its shareholders (argumentum ex article 377 of Polish Code Of Commercial Companies). If the directors have the ability to thwart takeover offer (by, for example, adopting defensive measures such as poison pills or selling crown jewels – this is not excluded under Articles of Polish Public Offer Act\textsuperscript{114}), then a value–maximizing takeover would pass over. Shareholders would lose out\textsuperscript{115}.

\textsuperscript{111}M. Kock, Mc Dermott, Will & Emery, Hostile Takeovers in Germany, Venulex Legal Summaries 2006, September 18, p.1.
\textsuperscript{112}K. Oplustil, Obrona... (cz. II), op. cit., p. 5.
\textsuperscript{113}R. Sasiak, Fuzje i przejęcia spółek publicznych [Mergers and acquisitions of public limited companies], Kraków 2000, p. 278, C. Podsiadlik, op. cit., Warsaw 2003, s. 83–84. Critically, see K. Oplustil, Obrona... (cz. II), op. cit., p. 4.
\textsuperscript{114}Argumentum a contrario ex Article 80a para 1; see K. Oplustil, Obrona... (cz. II), op. cit., p. 4.
Conclusion

Developing Pan-European *level playing field* is a difficult task. Transposition of *directors' passivity rule* can create core for European market for corporate control, by boosting its efficiency. Even though, such a move can be regarded as radical, is worth considering. This approach is less severe than complete neutralization of all the defensive structures of target company what would have been destroyable for national markets. Thus, between board’s activity and absolute neutralization of company, *tempered passivity* can be a happy medium. The legislator should revert a decisive role on applicability of defensive measures to the general meeting of shareholders. It is, presumably, fairer and more efficient for the final decision to be made by shareholders to avoid the risk of conflict of interests with directors. Board of directors should be deprived from all defensive measures beyond normal administration of company, except for searching for alternative bidder.

Many interests within the structure of company are contradictory. Board of directors is often in misalignment with shareholders. Shareholders and directors are in conflict with stakeholders. It is impossible to put all interests into align. The best way, but not without disadvantages, is to afford shareholders as residual claimants to decide whether to trigger defensive measures. EU Directive 2004/25 as unsatisfactory compromise should be changed soon. Subsequently, it will have an impact on structure of Polish law. The ability to reform normative terrain will be a litmus test of EU’s determination to build a truly cohesive and liberalized internal market.

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116 In Italy, outcome of imposition of absolute company’s neutralization (art. 16 Law 149/92) was predictable. Companies started giving up their listing (R. Lener, *op. cit.*, p. 412).
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