PRIVATE SALE OF CORPORATE CONTROL:
WHY THE EUROPEAN MANDATORY BID RULE IS INEFFICIENT

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ABSTRACT

On April 21, 2004, the European Community enacted the XIII Company Law Directive on Takeovers, whose primary purpose is the promotion of more efficient capital structures in Europe. The provision of a Mandatory Bid Rule (MBR) is among the several measures devised by the Directive to achieve this goal. The rule requires that anyone acquiring control of a listed company is obliged to make an offer to be addressed to all shareholders for all their holdings at a price at least equal to the highest price paid in the year prior to the acquisition. More specifically, in the intentions of the European legislator, the MBR would be designed to protect minority shareholders from value expropriations by opportunistic buyers, who seek control of the company to extract private benefits rather than to increase corporate cash flows. Moreover, by preventing value-decreasing transfers of controls, the rule would also lead to a reduction of the cost of equity capital.

In this paper, I rebut both these claims as misleading and show that the MBR is, in fact, an inefficient rule for Europe. There are two basic reasons underpinning my argument. First, the ability of a controlling blockholder to extract private benefits is basically a function of the legal system in which the controlled company is chartered. Thus, the number of value-decreasing transfers of control tends to be relatively low. Second, by raising the cost of acquisition, the MBR is likely to prevent value-increasing transactions. And because such cost is increasing in the size of private benefits, in Europe where private benefits tend to be relatively high, the MBR is likely to prevent a large number of value increasing transactions. Finally, the MBR both fails to protect minority shareholders, because it does not prevent the extraction of private benefits, and risks reducing corporate value by hindering value-increasing transactions.

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INTRODUCTION

On April 21, 2004, after almost three decades of debate, the European Community has finally approved the XIII Company Law Directive on Takeovers. Primary purposes of the new regulation are the promotion of an integrated capital market and the creation of more efficient corporate structures. The provision of a “European Mandatory Bid Rule” is among the several measures devised by the Directive to achieve these goals. The rule requires that anyone acquiring control of a listed company is obliged to make an offer to be addressed to all shareholders for all their holdings at a price at least equal to the highest price paid in the year prior to the acquisition. In this paper, I provide an analysis of the mandatory bid rule (MBR) as devised in the European Directive and assess its effects on private sales of control of listed companies.

The primary purpose of the MBR is the protection of minority shareholders from opportunistic buyers, who may seek control of the target to extract high private benefits of control rather than to increase cash-flows. The efficiency-based argument counterbalancing this distributive goal is that the rule, preventing all value-decreasing transfers of control, will reduce the firms’ cost of equity capital.

I claim that both the distributive-concerned and the efficiency-oriented claims underpinning the MBR are misleading. There are two basic reasons for this. First, I show that the ability of a controlling blockholder to extract private benefits does not depend on her “good” or “bad” nature, but is basically a function of the legal system in which the controlled company is chartered. It is, thus, unlikely that prospective buyers will be able to extract higher private benefits than incumbent controllers. In turn, the number of

value-decreasing transactions will tend to be relatively low. Potential buyers will, in fact, seek control to increase the corporate cash-flows rather than extract high DPB. Second, as the economic literature has long pointed out, the MBR may prevent value-increasing transactions from taking place by raising the costs of acquisition. The rule, indeed, imposes on perspective buyers to offer to all non-controlling shareholders the same control premium paid to the incumbent in compensation for the private benefits she loses by selling her block. Therefore, the MBR produces a sort of multiplier effect on the control premium to be paid by the buyer. Such additional cost is, then, increasing in the size of the private benefits that the incumbent extracts. Hence, when private benefits are relatively high, as it is the case in most European countries, the MBR is likely to prevent a large number of value increasing transactions.

Finally, I conclude that the MBR is an inefficient rule for Europe. On the one side, it fails to protect minority shareholders adequately, since it does not prevent the extraction of private benefits. On the other side, it compromises corporate efficiency, by preventing a large number of value-increasing transactions and, thereby, reducing firms’ projected value. For these reasons, the MBR risks jeopardizing the main objective of the Takeover Directive: the enhancement of the European capital market.

The analysis is developed in three parts. Part One gives account of the legal debate developed on private sales of corporate control and compares the different approaches adopted in the United States and Europe to mitigate the problem of private benefits. This part also offers some empirical evidence to clarify the dimensions of the problem of private benefits. Part Two, then, moves to discuss the Takeover Directive and, in particular, the MBR provided therein. First, it illustrates why a default approach rather than a mandatory harmonized approach (i.e., “level playing filed” approach) would have been desirable to foster the European takeover market. Second, it explains the reasons of the inefficiency of the MBR. In particular, drawing on some of the main contributions of
the economic literature on the matter, a simple analytical framework is developed to illustrate the efficient conditions for the parties’ exchange under different regulatory regimes. Three basic arguments are, then, discussed in support of the claim that the MBR is inefficient. First, it is shown that the private benefits extracted by incumbents and prospective controllers tend to be equivalent. Increased share value is the principal source of gain in transactions in control rather than extraction of higher private benefits. In turn, the primary purpose of the MBR, i.e., the prevention of value-decreasing transactions, makes little sense. Second, the higher the private benefits extracted by incumbent controllers, the larger the number of value-increasing transactions that are prevented by the MBR. This means that, when private benefits tend to be relatively high, as it is the case in most European Continental countries, the MBR reduce corporate wealth by preventing a large number of value-increasing transfers of control. Third, the MBR may lead to the potential increase of ownership concentration. Under the MBR regime, it might indeed be less expensive for prospective buyers seeking control of the corporation through a hostile rather than a friendly takeover. This, however, implies that incumbent controllers might be “expropriated” their private benefits without being compensated for. In turn, it seems reasonable to predict that when the controlling block is relatively large, but still contestable, incumbents will have incentives to consolidate their controlling interest. Finally, Part III concludes the work, discussing both the alternative legal instruments which could have been adopted in Europe to protect minority shareholders, and the potentially mitigating effect of efficient threshold policies over the MBR.
PART I

PRIVATE SALE OF CORPORATE CONTROL, CONTROL PREMIUM, AND PRIVATE BENEFITS

1. Some Preliminary Remarks

Private sales of corporate control, or sale-of-control transactions, are private agreements for the transfer of a controlling interest in a corporation. Unlike hostile takeover, sale-of-control transactions are the result of direct negotiations conducted outside the stock exchange between the current owner of a controlling block and a potential buyer. Commonly, the negotiation process proceeds as follows. The controlling blockholder and the potential buyer begin negotiations for the transfer of control. They sign a letter of intent and, most of the times, a confidentiality agreement as to the private information they will disclose to each other in the negotiation process. After the satisfactory conclusion of the buyer’s due diligence over the company, the parties finally negotiate the sale price and sign the acquisition agreement.

From this perspective, private sales of control can be described as “friendly” alternatives to hostile takeovers to obtain control of a corporation. This is true, however,

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3 Cf. G. William Schwert, Hostility in Takeovers: In the Eyes of the Beholder, 55 J. FIN. 2599-600 (2000) (affirming that parties tend to engage in confidential negotiations both in the case of friendly and hostile takeovers. In fact, the latter are often the result of a break down of private negotiations and of a party’s decision to disclose confidential information in order to enhance her bargaining position. Prospective bidders, for instance, might choose to reveal information to put pressure on management. Similarly, incumbents may disclose information to attract additional bidders. Confidentiality agreements serve, thus, to limit the risk of strategic behavior in takeover negotiation).

4 Id. Schwert points out that many “friendly” acquisitions are such only in name. Indeed, several acquisitions, which are perceived as friendly once the successful completion of negotiations is publicly
only when the ownership of the firm is highly dispersed and the controlling shareholder does not own a majority or substantial block of shares. In this case, the party seeking to acquire control might either approach the controlling shareholder for a private negotiation or make a general offer (i.e., a tender offer) open to all the company shareholders. When the corporate ownership is concentrated in the hands of a controlling shareholder, however, sale-of-control transactions represent the only way to acquire control of the corporation.

The different negotiation process characterizing private sales of corporate control and tender offers has substantial implications. In both cases, the buyer offers to purchase the company shares at a premium over their market price. In tender offers, however, the premium is set on the basis of market considerations, is publicly known, and is available, at least theoretically, to all shareholders. On the contrary, in sale-of-control transactions, the premium is privately negotiated, there is usually no public disclosure until after an agreement has been reached by the parties, and, above all, it goes only to the controlling shareholder. This exclusivity feature of the premium paid in sale-of-control transactions is indicated by referring to it as a “control premium”.

announced, would have been considered hostile should they have been disclosed to the public during the early stage of negotiations.

5 See, e.g., Paul Hanouna, Atulia Sarin, & Alan C. Shapiro, *Value of Corporate Control: Some International Evidence*, USC MARSHALL SCHOOL OF BUSINESS, WORKING PAPER NO. 01-4 (2001) 6 (discussing empirical evidence in support of the finding that when the controller owns more than 30 percent of the voting rights, it is very unlikely that a rival can gain control over the company through a hostile bid); Michael J. Barclay & Clifford G. Holderness, *Private Benefits of Control of Public Corporations*, 25 J. FIN. ECON. 371 (1989) (finding that, in a group of 114 NYSE and AMEX companies with large controlling block there were 21 sale-of-control transactions in the four-year period of 1978-1982).

6 Indeed, in tender offers, the bidder can offer to purchase just the 51% of the shares.
2. Control Premium and Private Benefits

Controlling blocks of stock are, thus, worth more than other stock and trade at a control premium over the market price.\(^7\) Why? Part of the economic literature justifies the higher value of controlling blocks by pointing at the “psychic” value some shareholders attribute simply to being in control.\(^8\) Still, as acutely observed, the “pleasure of command” falls short in explaining the multimillion dollar control premiums that buyers pay to controlling shareholders.\(^9\) The largely dominant economic view is that ownership of a control interest permits to extract “private benefits” unavailable to other shareholders,\(^10\) which may have both a dissipative or non-dissipative nature.\(^11\) Dissipative

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\(^9\) *Id.*

\(^10\) See, e.g., Michael J. Barclay & Clifford G. Holderness, *The Law and Large-Block Trades*, 35 J. L. & ECON. 265, 268-70 (1992); Clifford G. Holderness, *A Survey of Blockholders and Corporate Control*, ECON. POLICY REV. 51, 54 (2003). Both the articles distinguish between “shared benefits of control” and “private benefits of control”. The first are the benefits accruing to all shareholders from the presence of a large blockholder, such as the increase in firm value that might be produced by the more efficient monitoring on the firm’s management carried out by large shareholders. To this regard, see, also, *infra* note 22. The second, instead, are the benefits accruing only to controllers, which are mostly detrimental to minority shareholders’ interest.
private benefits (DPB) include, for instance, perquisites and other amenities enjoyed by top management, the diversion of corporate opportunities to the controller’s sole advantage, cost-sharing arrangements that overpay the controller for the services she furnishes to the company, unfair transfer pricing and other forms of self-dealing, etc. Examples of non-dissipative private benefits (NDPB) comprise, instead, the increase in the controller’s reputational capital deriving from the ownership of the controlling interest, or the controller’s ability to explore business opportunities that the company cannot or does not want to undertake.

DPB are value-expropriating. They increase the wealth of the controlling blockholder to the detriment of the minority (i.e., non-controlling) shareholders. There is a one-to-one correspondence in the controlling blockholder’s gain and the minority shareholders’ loss. Still, DPB tend to represent more a distributive than an allocative problem. From this perspective, the value of corporate control can be said to rest on the

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13 See, e.g., Shleifer & Vishny supra note 7, passim; Dyck & Zingales supra note 7, at 541; Barclay & Holderness, supra note 10, at 269; Berglöf & Burkart, supra note 11, at 192; Demsetz & Lehn, supra note 11, passim.

14 Stanford J. Grossman & Oliver D. Hart, Takeover Bids, the Free-Rider Problem, and the Theory of Corporation, 11 BELL J. ECON. 42 (1980) (pointing out that even if the extraction of DPB generates some inefficiency (i.e., the expropriation of minority shareholder), their existence might be “socially
power of the controlling blockholder to allocate the cash-flows of the firm differently. Non-dissipative private benefits (NDPB), on the contrary, are value-creating.\textsuperscript{15} They increase the utility of the controlling blockholder without expropriating value from the minority shareholders. Hence, their extraction is always Pareto-efficient.

A sale of control transfers, then, two different assets: the controlling block of stock plus the appropriable DPB.\textsuperscript{16} The transfer of control is indeed another way—an indirect one—through which controlling shareholders may extract DPB.\textsuperscript{17} NDPB, instead, are not usually traded because they tend to have an idiosyncratic nature and, therefore, potential buyers are reluctant to pay for them.\textsuperscript{18} A sale of control will, thus, take place when the

\begin{itemize}
\item \textsuperscript{15} Cf. Bebchuk, \textit{supra} note 2, at 979 (stating that private benefits may be surplus-producing, without coming “at the expense of the values flowing to shareholders.”)
\item \textsuperscript{16} Cf. Stern, \textit{supra} note 2, at 517 (affirming that control of the corporation is “undoubtedly an independent asset” and that, in sale-of-control transactions, “the purchaser … receive[s] two separate and independent asset: a specific quantity of shares […] and the control of the corporation.”)
\item \textsuperscript{17} Gilson & Gordon, \textit{supra} note 12, at 793. The authors individuate three methods in which a controlling shareholder may extract private benefits. The first one is the “direct extraction” of private benefits in operating the company. For instance, blockholders can take strategic decisions to their exclusive benefit or engage in self-dealing with the corporation. The second one is, instead, the “indirect extraction” through the sale of corporate control at a premium that reflects the capitalized value of the private benefits available from operating the controlled company. The third is, again, a form of indirect extraction. Private benefits can be appropriated also by freezing out minority shareholders at a market price that reflects a discount equivalent to the private benefits of control available from operating the controlled company.
share value of the controlling block plus the net present value of the appropriable DPB is higher for the buyer than for the incumbent controller. From this perspective, the higher trading value of controlling blocks of stock is attributable to two factors: the higher expected value of the shares under the buyer’s management, and the existence of appropriable DPB. A common way to “measure” the DPB extracted by incumbent controllers is, thus, to compute the difference between the price per share paid for the control block and the market price after the announcement.\(^\text{19}\) Such a number will reflect, in fact, the capitalized value of the DPB available from operating the controlled corporation.

The potential for the extraction of DPB inherent to the ownership of a controlling interest constitutes the crucial agency problem that arises between non-controlling and controlling shareholder.\(^\text{20}\) Still, the presence of a controlling shareholder mitigates the core agency problem affecting the modern public corporation: the conflict between diffuse shareholders and professional managers. Monitoring the management proves easier when the ownership of the firm is concentrated in the hand of a controlling

\(^\text{19}\) This is the method used, for instance, by Dyck & Zingales, *supra* note 7; and pioneered by Barclay & Holderness, *supra* note 5. An alternative method to quantify the size of DPB extracted by controllers is to measure the price difference between two classes of stocks, with identical dividend rights, but different voting rights. This is the method used, for instance, by Rydqvist, *supra* note 7; and Hanouna, Sarin, & Shapiro, *supra* note 5. Still, DPB are, by their very nature, difficult to observe and even more difficult to measure. Indeed, if DPB were easily verifiable (i.e. provable in courts), non-controlling shareholders would be able to prevent controllers from appropriating them. As a result, each method presents both advantages and disadvantages. Dyck & Zingales, at 538.

shareholder rather than dispersed.\textsuperscript{21} Non-controlling shareholders face thus a trade-off. Concentrated ownership reduces the managerial agency problem, but at the cost of the DPB agency problem. For this reason, only when the reduction of managerial agency costs is greater than the value expropriation resulting from the extraction of DPB will non-controlling shareholders prefer the presence of a large shareholder.\textsuperscript{22}

Empirical evidence suggests the dimensions of the phenomenon.\textsuperscript{23} In the United States, DPB, calculated in the way above-described, amounts on average to 1% of the purchase price paid by the buyer to the controlling shareholder.\textsuperscript{24} Europe presents a more variegated picture. In the United Kingdom (practically, the sole European market-based country), DPB are just the 2% of the purchase price.\textsuperscript{25} In the so called bank-based countries, instead, there is no uniformity. In a first block of countries, including Austria, Czech Republic, Italy, and Portugal, DPB tend to account (on average) for a large part of the purchase price (respectively, for the 38\%, 58\%, 37\%, and 20\%).\textsuperscript{26} In a second block, composed of Denmark, Finland, France, Germany, Netherlands, Spain, and Sweden, DPB tend, instead, to account (on average) for a relatively small part of the purchase price (respectively, for the 8\%, 2\%, 2\%, 10\%, 2\%, 4\%, and 7\%).\textsuperscript{27}

\textsuperscript{21} \textit{Id.} See also Berglöf & Burkart, \textit{supra} note 11, at 192; Holderness, \textit{supra} note 10, at 54; Denis &. McConnel, \textit{supra} note 14, \textit{passim}.
\textsuperscript{22} \textit{Id.} (“Non-controlling shareholders will prefer the presence of a controlling shareholder so long as benefits from reduction in managerial agency costs are greater then the cost of private benefits of control.”)
\textsuperscript{23} Source: Dyck & Zingales, \textit{supra} note 7, at 551 (data for 1990-2000).
\textsuperscript{24} \textit{Id.}
\textsuperscript{25} \textit{Id.}
\textsuperscript{26} \textit{Id.}
\textsuperscript{27} \textit{Id.}
From the available data, however, it seems difficult to individuate any macroeconomic determinants of the DPB size. All the predictable correlations look weak. The level of ownership concentration, for example, which at first sight could appear as a significant index, does not seem conclusive in actuality. (Italy and Germany are two examples of countries in which corporate ownership tends to be highly concentrated; still, the size of DPB in Italy is almost four times larger than in Germany.)\(^28\) Similarly, no bright line could be drawn between market-oriented and bank-oriented countries. (The case of most North European countries, for example, in which DPB tend to be low, disavows the idea that in bank-oriented countries DPB are necessarily higher).\(^29\) Finally, the sole determinant of the DPB size that the empirical evidence seems to support is, as I will discuss in more detail later,\(^30\) the quality of the legal system in which a corporation operates.\(^31\)

3. Private Sales of Control in the United States and Europe

Whether and to what extent transfers of corporate control should be regulated has been the subject of an ever-going debate. At one extreme, claimants of a value-

\(^{28}\) The median controlling block in these countries measures, respectively, 54.5% (Italy) and 57% (Germany). Still, DPB in Italy measure 38%; in Germany, 10%. (Sources: on ownership concentration, Marcello Bianchi, Magda Bianco, & Luca Enriques, Pyramidal Groups and the Separation between Ownership and Control in Italy, FABRIZIO BARCA & MARCO BECHT, THE CONTROL OF CORPORATE EUROPE 19, 168 (2002) (data for 1996); and Marco Becht & Böhmer, Ownership and Voting Power in Germany, ID., at 19, 142 (data for 1996); on the size of DPB: Dyck & Zingales, supra note 7, at 551.

\(^{29}\) For the data, see supra at note 27.

\(^{30}\) See infra Par. 2.3.1.

\(^{31}\) See Rafael La Porta, Florencio Lopez-de-Salines, & Andrei Shleifer, Investor Protection and Corporate Governance, 59 J. FIN. ECON. 3 (2000) [hereinafter La Porta, Investor Protection]; Rafael La Porta, Florencio Lopez-de-Salines, Andrei Shleifer, & Robert W. Vishny, Law and Finance, 6 J. Pol. ECON. 1113 (1998) [hereinafter La Porta, Law & Finance]. The authors discuss empirical evidence supporting the claim that better protection of minority shareholders (i.e., more effective legal rules) is correlated with higher financial development via its curbing of DPB.
maximizing view of transactions in control support a deregulatory position. Under this view, transfer-of-control transactions are undertaken in order to increase the equity share price of the target corporation. Both private sales of control and tender offers are considered key-mechanisms for replacing inefficient management and allocate corporate assets to higher and better uses. In turn, regulatory measures are seen as detrimental because they hinder the transfer of control.

At the other extreme, supporters of a non-value-maximizing view of transactions in control demand that such transactions be regulated. Under this view, transfer of control are undertaken to maximize the buyer’s utility rather than the corporate wealth. In the case of private sales of control, this means that the buyer is willing to pay a premium not because she expects to improve the firm management, but to extract larger DPB than the incumbent controller. Regulation is, thus, necessary to prevent expropriation of shareholder value.


See, e.g., Romano, supra note 32, at 129 (“The most important agency cost explanation of takeovers is that they reduce managerial slack by replacing inefficient management.”) The first to put forth this view has been Henry Manne, who defines takeovers as the key mechanisms of the market for corporate control for disciplining managers, because takeovers—unlike mergers, which require the board’s 

See, e.g., Romano, id.; Easterbrook & Fishel, supra note 32, at 698.

Romano, supra note 32, at 145-52 (reporting four non-value-maximizing expropriation explanations: diversification; self-aggrandizement; free cash flow excess by acquirers, and the hubris hypothesis).
Still, every jurisdiction has introduced at least minimal regulatory requirements for tender offers. By contrast, different solutions have been adopted to regulate private sales of control and, in particular, the allocation of the control premium paid by the buyer.

3.1. Private Sales of Control in the United States

In the United States, the sixty-year old controversy on private sales of control has focused primarily on the legitimacy of the exclusive appropriation by the incumbent of the control premium paid by the buyer. Three main theories on the allocation of control premiums have emerged from this long-standing debate: (i) the corporate asset theory devised by Professors Berle and Means; (ii) the so-called “equal-sharing rule” proposed by Professor Andrews; and (iii) the deregulatory approach supported by law-and-economics scholars.

Conceiving of the corporate control as an asset belonging to the corporation, Berle and Means claim that the premium paid for it by the buyer should be transferred directly

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39 The strongest proponents of the deregulatory approach are Frank Easterbrook and Daniel Fischel. See Easterbrook & Fischel, supra note 32, at 698. (“Any attempt to require sharing simply reduces the likelihood that there will be gains to share.”).
to the corporation.  

For Andrews, instead, corporate control neither belongs to the controlling blockholder nor is a corporate property. Rather, corporate control is vested in every share, and each shareholder owns a part of it in proportion to the number of shares that she holds. Thus, the equal-sharing rule commands that the control premium be allocated to all shareholders proportionally to the number of shares they hold. The rule is addressed both to the incumbent controller and the potential buyer. On the one hand, the controller may sell her block to an outsider only if he provides that the purchase offer is made equally available to all the non-controlling shareholders. On the other hand, the buyer cannot acquire a controlling block if she does not make the control premium equally (or, at least, proportionally) available to all shareholders. 

In contrast to both the corporate asset theory and the equal-sharing rule, law-and-economics scholars support the view that control premiums belong to controlling shareholders exclusively. Although different economic justifications have been offered under the deregulatory approach, a common argument can be individuated. Imposing a “sharing principle” on controlling shareholders would reduce the frequency of sale-of-

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40 Berle and Means distinguish between voting power, which vest shareholders with an owner’s right in making use of their shares, and concentration of voting rights, which give shareholders a de facto control on the corporation, but do not vest them with ownership of such control. BERLE & MEANS, supra note 37, at 216-7.

41 Andrews, supra note 38, at 515-517.

42 Id., at 506, 516.

43 Id.

44 For instance, Barclays and Holderness have proposed to distinguishing between blockholders acting “qua managers” (as most do) or “qua owners” (i.e., as sellers of a controlling interest in the corporation). In the first case, the blockholder would be constrained her duties as corporate fiduciary and, therefore, should “follow the principle that any distribution to shareholders be in proportion of their fractional shares”. In the second case, instead, the blockholder would be free to “keep all proceeds”. Barclay & Holderness, supra note 10, at 292.
control transactions by imposing additional costs on buyers and, therefore, prevent the occurrence of value-maximizing transfers of control.\footnote{Cf. Alan Schwartz, \textit{Search Theory and the Tender Offer Auction}, 2 J. L. ECON. & ORG. 229, 249 (1986) (arguing that when the buyer’s expected welfare from the takeover of the corporation is reduced because of regulatory measures, the likelihood of value-maximizing transactions in control is correspondently reduced. In fact, the buyer would lose incentives even to invest in information about potential target companies.)}

American courts, however, seem not to have been much influenced by the several academic theories formulated on private sales of control.\footnote{See Hamilton, \textit{supra} note 36, at 261-62.} The “long-settled law” is that a controlling shareholder does not need to share the control premium with non-controlling shareholders.\footnote{Zetlin v. Hanson Holdings, Inc, 48 N.Y. 2d 684, 397, N.E. 2d 387 (1979) is, probably, the most quoted case on the blockholders’ exclusive right to the control premium. (“Recognizing that those who invest the capital necessary to acquire a dominant position in the ownership of a corporation have the right of controlling the corporation, it has long been settled law that, …, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price.”) For a detailed discussion of the case, see Hamilton, \textit{supra} note 36, at 248-51. \textit{See also} Doleman v. Meiji Mut. Life Ins. Co., 727 F.2d 1480 (9\textsuperscript{th} Cir. 1984); Delano v. Kitch, 663 F.2d 990 (10\textsuperscript{th} Cir. 1981); Treadway Companies v. Care Corp., 638 F.2d 357 (2d Cir. 1980). For an early statement of the “long settled law”, see Stanton v. Schenck, 140 Misc. 621, 251 N.Y.S. 221 (1931).} The rejection of any sharing principle, however, is based more on the courts’ concern of interfering in arms-length commercial transactions than on economic-efficiency considerations. Absent a “clear and visible harm”\footnote{See Hamilton, \textit{supra} note 36, at 262.} to the corporation or its (non-controlling) shareholders, there is no justification for frustrating party autonomy and “regulating” private sales of control.

On the basis of this principle, American courts have traditionally acknowledged three exceptions to the general rule that controlling shareholders are free to sell their block at a control premium unavailable to non-controlling shareholders. The first is the
sale to suspected looters. The incumbent-seller owes to the corporation “a duty of reasonable investigation and due care” when the circumstances raise a reasonable suspicion that the prospective buyer intends to use control to loot the corporation. The second exception occurs when the premium to the controlling shareholder is actually paid in consideration of the latter’s resignation from her position as a corporate officer or director. Accepting payment for a “sale of office” is indeed illegal. The exception, however, has been applied basically only when the premium was an apparent side payment for a sale of office. Finally, courts have held controlling shareholders liable toward the corporation when the sale of control effectively “diverts” a corporate opportunity to the exclusive benefit of the controlling shareholder. Thus, in Perlman v. Feldmann, probably the most celebrated case on the diversion-of-corporate-opportunity exception, the court found the controlling shareholder guilty of having “siphon[ed] off for personal gain corporate advantages” and it (exceptionally) required him to share the control premium with the non-controlling shareholders.


51 See, e.g., Hamilton, supra note 36, at 270; Elhauge, supra note 36, at 1469-73.


53 Another major case is, then, Sinclair Oil v. Levien (280 A.2d 717 (Del. 1971)). For a detailed discussion of the case, see Gilson & Gordon, supra note 12, at 789-91. For an early statement of the exception, see Commonwealth Title Ins. & Trust Co. V. Seltzer, 227 Pa. 410, 76 A. 77.
3.2. Private Sales of Control in Europe

Unlike in the United States, in Europe private sales of corporate control have been traditionally regulated. Neither European legislators nor courts, however, have chosen to regulate such transactions specifically; rather, the great majority of EU countries\(^{54}\) have adopted a sharing principle in the form of a mandatory bid rule (MBR) provision that equally applies to friendly and hostile takeovers. Such a rule requires that an offer to all shareholders be made when a certain percentage of the company shares (i.e., the control threshold) is purchased. Only recently, however, with the adoption the XIII European Company Law Directive on Takeovers in April 2004, uniform MBR provisions have been introduced across the several EU jurisdictions.\(^{55}\)

Yet, reaching an agreement on Article 5 of the Directive, which sets the rules and common principle of the new “European MBR”, has not been a smooth process.\(^{56}\) On the contrary, the European MBR (and, more generally, the European Directive) has a long and troublesome history. The first draft directive on takeovers dates back to the 1970s (the so-called “Pennington Report”).\(^{57}\) Successive proposal were presented at the end of

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\(^{54}\) The Netherlands and Sweden are two exceptions.

\(^{55}\) See supra note 1. As a result of the Directive’s enactment, also the Netherlands and Sweden will have to adopt a MBR provision.

\(^{56}\) The path for the adoption of the directive has been colorfully defined as an endless saga. See Rolf Skog, The Takeover Directive – an Endless Saga, 13 EUROPEAN BUS. L. REV. 301 (2002).

\(^{57}\) The Pennington Report drew largely on the UK City Code on Takeovers and Mergers and on the French and Belgian regulations on takeover bids. The MBR proposal included in the Report provided that the mandatory offer by the potential buyer was triggered when: (a) a natural person or legal entity obtained a shareholding representing at least 40% of the total voting rights in a company; (b) a shareholder within the period of 1 month acquired shares representing at least 20% of the total voting rights; or (c) a shareholder pledged to acquire enough shares to obtain a voting majority in the company. As to the offer’s price, the Report provided that this should have been the highest paid to the controlling shareholder in the last 12 months. For a detailed review of the Pennington Report, see Rolf Skog, Does Sweden Need a
the eighties, first in occasion of the implementation of the internal market (the so-called “1987 Commission’s Draft Directive”),\(^58\) and, soon after, as a response to a series of cross-border hostile takeovers that procured scandals and tension among the Member States (the so-called “1989 Commission’s Directive Proposal”).\(^59\) In 1990, still another proposal was presented (the so-called “1990 Commission’s Revised Directive Proposal”).\(^60\) Finally, in 2000, the Commission appointed a new group of company law experts (the Winter Commission), whose work is at the basis of the proposal definitely adopted in April 2004.

The reasons of the troubled path of the European MBR lie in the Member States’ difficulty of finding an agreement on two basic features of the rule: the control threshold and the mandatory offer’s price. The dispute on the control threshold is explained by its great influence on the level of authorized free trades of controlling blocks. It is indeed apparent that, depending on the level of ownership concentration, the adoption of different thresholds is fundamental to restrict or enlarge the number of free control

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\(^{58}\) The MBR provision included in the 1987 draft proposal differed substantially from the one of the Pennington Report. The different control thresholds, for instance, were restricted to two alternatives only (one half or two third of the outstanding shares), leaving the Member States free to adopt either one or the other. Furthermore, in the draft proposal’s provisions the MBR applied only if the threshold was triggered as a consequence of a public takeover bid. In addition, no mandatory rule was provided as to the offer’s price. The draft proposal simply recommended that the MBR price should not have been lower than a certain percentage of the price paid in the initial bid. \textit{Id.}, at 3.2.

\(^{59}\) The only relevant difference between the 1987 and the 1989 Proposal was the amendment of the provision on the threshold, which was definitely fixed at one-third of the voting rights. \textit{Id.}, at 3.3.

\(^{60}\) The Commission’s Revised Directive Proposal introduced a whole series of exemptions to the MBR. In addition, it did not contain any provision as to the mandatory offer’s price. Thus, the failure of this proposal did not come much as a surprise. The MBR set therein was so easy to circumvent that its adoption would have been virtually indifferent.
transfers.\textsuperscript{61} For instance, in a country like the United Kingdom (the first, in Europe, to adopt a MBR provision),\textsuperscript{62} where corporate ownership is highly dispersed (the median controlling blockholder holds 9.9\% of the company shares),\textsuperscript{63} a 30\% threshold significantly reduces the restrictive effect of the MBR on private sales of controls. On the contrary, the same control threshold makes unregulated private sales of control practically impossible in Italy and Austria, where the median controlling shareholder holds, respectively, the 54.5\% and 52\% of the outstanding shares.\textsuperscript{64} Regardless of the level of ownership concentration, it is then obvious that, when the control threshold is very high (as in the case of Finland, where it is fixed at 67\%), the incidence of the MBR on sale-of-control transactions is limited.

As to the price provision, the dispute arises from the different costs that the MBR may impose on the prospective buyer depending on the mechanics of price determination. Two different approaches have been traditionally adopted by EU countries. The first,

\begin{itemize}
\item \textsuperscript{61} Cf. Berglöf & Burkart, \textit{supra} note 11, at 176 (stating that “the effects of the mandatory bid rule … of the type proposed by the Winter Group depend on the ownership and control structure in target firm.”)
\item \textsuperscript{62} The City Code on Takeover and Mergers, which was adopted in the UK in 1968, has represented the basic model for the European Directive on Takeovers. See Skog, \textit{supra} note 57.
\item \textsuperscript{64} Sources: on Italy, see \textit{supra} note 28; on Austria, Klaus Gugler, et al., \textit{The Separation of Ownership and Control in Austria}, in BARCA \& BECHT, \textit{supra} note 28, at 19, 49 (data for 1996). Unregulated private sales are still possible in France where the threshold is set at 33\% and the median controlling blockholder controls with 20\% of the shares. Sources: Laurence Bloch & Elizabeth Kremp, \textit{Ownership and Voting Powers in France}, in BARCA \& BECHT, \textit{supra} note 28, at 19, 112-116 (data for 1996). Rarely, unregulated private sales can occur in Germany and Spain where the threshold is 30\% and 25\% respectively; and the median controlling shareholder controls with 57\%, and 34.5\% respectively. Sources: on Germany, see \textit{supra} note 28; on Spain: Rafael Crespi-Cladera & Miguel A. Garcia-Cestona, \textit{Ownership and Control of Spanish Listed Firms}, in BARCA \& BECHT, \textit{supra} note 28, at 19, 217-222 (data for 1996).
\end{itemize}
introduced by the UK City Code on Merger and Acquisition, provides that the mandatory offer’s price must be equivalent to the highest price paid for the company shares in the last 12 months. (Presumably, such a price will be the price paid by the prospective buyer to the controlling blockholder.) The second approach, instead, provides for an “adjusted mechanic” of price determination that reduces the costs of the mandatory offer. In Italy, for example, the offer’s price is determined on the basis of the arithmetic mean between the highest price paid for the company shares in the last 12 months (i.e., the price paid to the controlling blockholder) and the average market price of the shares during the same period.\(^{65}\)

The controversial compromise reached by Article 5 provides that an offer to all shareholders at “an equitable price” be made when a party acquires “a specified percentage of voting rights … giving him/her control of that company … as determined by the rules of the Member States in which the company has its registered office.” At first sight, then, each Member State seems remaining free to determine its national control threshold. At a closer look, however, whether Member States will effectively have unconditioned freedom in the threshold policy is less clear. Considering the somehow vague wording of the provision, it cannot be excluded that the Commission, in order to make the MBR meaningful, might require Member States to set their control thresholds at a level below the national mean controlling block.\(^{66}\) In addition, it seems almost certain

\(^{65}\) Italian Consolidated Financial Services Act of 1998. Similarly, the Austrian Takeover Law of 1999 provides that the bid price should be at least equal to the average stock exchange price in the 6 months the controlling block’s purchase.

\(^{66}\) See Mike Burkart & Fausto Panunzi, Mandatory Bids, Squeeze-Out, Sell-Out and the Dynamics of the Tender Offer Process, in FERRARINI ET AL., supra note 18, at 748, fn. 39 (observing that, given the mandatory harmonized approach adopted by the Directive, “it seems puzzling that the Commission does not also impose a common thresholds for triggering mandatory bids.”) See also André Nilsen, The EU Takeover Directive and the Competitiveness of European Industry 9, research in progress, available at
that countries with very high thresholds, like Finland, will be required to adopt lower thresholds.

The key provision of the European Directive, however, is the adoption of the UK approach as to the mechanics of price determination. To be “equitable”, in fact, the offer’s price must be “the highest price paid for the same securities by the offeror, … , over a period, to be determined by Member States, of not less than six months and not more than 12 before the bid.” From a practical viewpoint, this means that, except under the limited circumstances in which an exemption can be granted by the relevant national supervisory authority,67 no discrimination between the price paid by the buyer to the incumbent controller and that to be offered to the non-controlling shareholders will no longer be allowed.

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67 Precisely, Article 5 provides that:

Member States may authorize their supervisory authority to adjust the [fair]price […] in circumstance and in accordance with criteria that are clearly determined. To that end, they may draw up a list a list of circumstances in which the highest price may be adjusted either upwards or downwards, for example where the highest price was set by agreement between the purchaser and the seller, where the market prices of the securities in question have been manipulated, where market prices in general or certain market prices in particular have been affected by exceptional circumstances, or in order to enable a firm in difficulty to be rescued. They may also determine the criteria to be applied in such cases, for example the average market value over a particular period, the break-up value of the company or other objective valuation criteria generally used in financial analysis.
PART II

WHY THE EUROPEAN MBR IS AN INEFFICIENT RULE FOR EUROPE

1. The Lost Opportunities of the European Directive on Takeovers

Europe needs corporate restructuring and capital market integration to be competitive in a worldwide market economy. The instrument devised by the European Union to ensure the achievement of this goal is the Thirteen European Directive on Takeovers. In the belief of the EU legislator, a “level playing field” regulation on takeovers will enhance productive and allocative efficiency, preventing that national company laws might distort the market for corporate control. This, in turn, will foster industrial restructuring and lead to higher firm valuations.⁶⁸ In this context, the protection of minority shareholders guaranteed by the European MBR is conceived of as a fundamental tool to promote value-maximizing takeovers and prevent the expropriation of minority shareholders by a controlling blockholder. The underpinning efficiency argument is that a rule that provides shareholders with “adequate” and “fair” terms of exit will reduce the cost of equity capital and, ultimately, enhance corporate efficiency.⁶⁹

The MBR is probably the best example of the overlapping between efficiency-oriented objects and distributive concerns that characterizes the European Directive on Takeovers. My claim is that such an overlapping is likely to transform the Directive in a “lost occasion”. There are two fundamental reasons for this. First, the distributive concerns underlying the harmonized mandatory approach of the European takeover

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⁶⁹ See Luca Enriques, supra note 18, at 767, 791 (illustrating five possible rationales for the MBR, including that of the companies’ lower cost of capital, and demolishing all of them).
regulation risks to frustrate rather than promote the development of the European capital market. Second, the adoption of rules, such as the MBR, that confuses distributive concerns and efficiency is likely to prove more detrimental than beneficial for the protection of minority shareholders’ interests.

1.1. The “Level Playing Field” Takeover Regulation

The harmonized mandatory rules provided by the Directive do not suit the widely diversified control and ownership patterns characterizing European countries.70 For instance, the MBR will have a relatively low impact when corporate ownership is widely dispersed. When corporate ownership is highly concentrated, however, such a rule will tend to prevent corporate acquisitions, becoming, in practice, an anti-takeover defense.71 In addition, harmonization limits the contractual choice of law. As acutely pointed out, in a harmonized regime, “firms cannot escape their natural legal regime so to move toward more efficient legal rules and improve the shareholders’ wealth.”72 Still, mandatory rules restrict freedom of contract, preventing parties from finding optimal rules.73 Finally, the harmonization regime imposed by the Directive is in contrast with the approach of the European Court of Justice that explicitly allows for legislative competition between the

70 In similar terms, see Burkart & Panunzi, supra note 66, at 762; Bergström, Högfeldt, & Molin, supra note 12, at 447; McCahery ET AL., supra note 68, passim.

71 See Bergström, Högfeldt, & Molin, supra note 12, at 448 (“[I]t is no coincidence that several U.S. corporate managers have proposed that the MBR be introduced in their article of incorporation. The principle serves as a defense against hostile takeovers since it checks rather than stimulates acquisitions.”) In similar terms, see Berglöf & Burkart, supra note 11, at 202-5.


73 See Berglöf & Burkart, supra note 11, at 209-10 (Discussion-Julian Franks, London Business School).
company laws of the several Member States.\textsuperscript{74} The expected reduction in transaction costs that should derive from the adoption of standardized rules falls short of compensating for all these inefficiencies.\textsuperscript{75}

A default regime of rules would have been a better choice to promote a competitive European capital market. A default takeover regulation, supported by a few strong recommendations of the Commission as to some basic common principles, would have secured a beneficial competitive pressure among Member States in corporate lawmakers.\textsuperscript{76} Furthermore, the adoption of default rules would have not impaired private autonomy and permitted parties to devise optimal solutions. The market itself, then, would have judged the desirability of such rules.

This alternative regulatory choice would have been particularly beneficial in the case of the MBR provision. It cannot be \textit{a-priori} excluded that the MBR, in specific circumstances, might be an efficient instrument to raise equity capital at a cheaper cost. Such a decision, however, should be left to the equity owners of the corporation and, ultimately, to the market. When the MBR is desirable, which the control threshold should

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\textsuperscript{74} The European Court of Justice (ECJ) has steadily endorsed a pro-competition policy, grounded on the founding principle of freedom of establishment. The groundbreaking judgment are \textit{Centros Ltd. v. Erhvervs-og Selskabsstyrelsen} ECJ C-212/97 [9.3.1999], and \textit{Übersseing BV v. Nordic Construction Company Baumanagement} ECJ C-208/00 [5.11.2002]. See Jaap Winter, \textit{The Need for a Regulatory Framework}, in FERRARINI ET. AL., \textit{supra} note 18, at 7-10, 13.

\textsuperscript{75} In similar terms, see Enriques, \textit{supra} note 18, at 768; \textit{see also} Hertig & McCahery, \textit{supra} note 72, at 39-40.

\textsuperscript{76} \textit{Cf.} Jonhatan Macey, \textit{Takeover Defensive Tactics and Legal Scholarship: Market Forces vs. the Policymakers’ Dilemma}, 96 YALE L. J. 342 (1987) (describing the dilemma faced by policymakers opting for “single and comprehensive” rules. Such rules, indeed, are intrinsically unable to represent the best choice for addressing the interests of all the parties concerned).
be, and which the fair price is, should be up to the judgment of the market.\textsuperscript{77} The European legislator, instead, have gone in the opposite direction and introduced a strict MBR. The fact that the rule leaves Member States “free” to determine their national control threshold seems not enough to promote competition, especially considering the uncertain wording of Article 5.\textsuperscript{78} On the contrary, mandating the highest price as the equitable exit price clearly restrains regulatory competition that could have lead to a substantial reduction of the mandatory offer’s costs.\textsuperscript{79}

\textit{1.2. The European MBR}

A private sale of control is efficient when it increases the value of the firm. The regulation of private sales of control is, then, socially desirable only if the market itself is not able to allocate resources efficiently. From this perspective, the common rationale for the MBR is that such a rule prevents (all) inefficient (i.e., value-decreasing) transfers of control.\textsuperscript{80} By requiring the prospective buyer to offer the control premium to all the company’s shareholders, the MBR ensures that a sale of control takes place only if the buyer is able to create sufficient added value (i.e., cash-flows) to offset the increased cost of acquisition that are imposed by the MBR sharing principle. Put more simply, the MBR prevents corporate acquisitions motivated exclusively by the buyer’s expectation to extract higher DPB than the incumbent controller. The concern, however, is not merely distributive. The enhanced protection of non-controlling shareholders would, in fact,

\begin{itemize}
\item \textsuperscript{77} This is the choice, for instance, of the Swiss legislation, which provides that companies, before being listed, may chose in their by-laws to opt out of the MBR provision to allow partial bids from perspective buyers.
\item \textsuperscript{78} Still, as it will be illustrated in detail \textit{infra}, threshold policies may play a role in mitigating the effect of the MBR. \textit{See infra} Par. 3.2.
\item \textsuperscript{79} In the same terms, Hertig & McCahery, \textit{supra} note 72, at 36.
\item \textsuperscript{80} \textit{See} Luca Enriques, \textit{supra} note 18, at 767, 791.
\end{itemize}
result in a lower cost of equity capital. By preventing the acquisition of control from opportunistic buyers, the MBR increases the value of minority shareholdings. In turn, investors would be willing to buy minority participation at a higher price, which would ultimately reduce the firm’s cost of equity capital.

On the other side, the economic literature has long pointed out that the MBR may prevent value-increasing sales of control as well. The equal-sharing rule can inflate the total purchase price beyond the buyer’s reservation price and, thereby, prevent that shareholders may benefit from the increased value that their stock would have under the buyer’s management. It follows that the MBR can be considered efficient only if the aggregate value of the inefficient transactions that it deters is higher than the aggregate value of the efficient sales of control that would occur in its absence.\(^1\)

There are basically three reasons why this is unlikely to be the case, at least in Europe. First, the size of the DPB extracted by prospective buyers tends to be equal to that extracted by incumbent controllers because “both parties face the same legal rules and quality of law enforcement.”\(^2\) Second, when corporate ownership is concentrated, as it is in most Continental Europe countries,\(^3\) the number of value-decreasing transactions will tend to be relatively low. Indeed, the share value loss due to the buyer’s extraction of higher DPB would be internalized for the great part by the controlling block and, thereby, by the buyer herself. Third, under a MBR regime, the number of value-increasing transactions is decreasing in the size of the DPB. Hence, given the relatively large size of

\(^1\) See Bebchuk, \textit{supra} note 2, at 960; Burkart & Panunzi, \textit{supra} note 66, at 752; Berglöf & Burkart, \textit{supra} note 11, at 197; Bergström, Högfeldt, & Molin, \textit{supra} note 12, at 434; Clas Bergström et al., \textit{The Regulation of Corporate Acquisition: A Law and Economics Analysis of European Proposals for Reform}, 1995 \textit{COL. BUS.L. REV.} 495.

\(^2\) Bergström, Högfeldt, & Molin, \textit{supra} note 12, at 447.

\(^3\) See Burkart & Panunzi, \textit{supra} note 66, at 758; BARCA & BECHT, \textit{supra} note 28, at 19.
DPB in Europe, the MBR tends to prevent a very high percentage of value-increasing transfer of controls. Fourth, when corporate ownership is concentrated and the DPB extracted by the incumbent controller are high, the MBR may make hostile takeovers a less onerous way to gain control of the company. This, however, may induce incumbent controllers to increase the size of their block in order to prevent being expropriated of corporate control by hostile bidders, with the ultimate result that control contestability will be reduced.

2. The Analytical Framework

Drawing on Grossman & Hart (1980), Bebchuck (1994), Bergstrom, Hogfeldt, & Molin (1997), Bergstrom & Hogfeldt (1997), and Burkart & Panunzi (2003), the following analysis explores the trade-off between value-increasing and value-decreasing transactions under a MBR regime and aims at clarifying why the adoption of such a rule is inefficient in Europe. The analysis is developed in two parts. In the first, I identify the conditions under which the sale of control is efficient for the incumbent controller and the prospective buyer. In the second, I discuss how the efficient conditions of exchange vary depending on the nature of the underlying regulating regime. In particular, I consider the following regimes:

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85 Bebchuk, supra note 2.
86 Bergström, Högfeldt, & Molin, supra note 12.
88 Burkart & Panunzi, supra note 66.
(i) the market regime, in which no sharing principle applies and the control premium paid by the buyer goes exclusively to the incumbent controller. This is the case, for instance, of the United States and, currently, of the Netherlands and Sweden;

(ii) the MBR regime, in which the buyer’s offer must be made available to all the company shareholders at a price equivalent to the latest highest price paid for the company shares (which is, presumably, the price paid by the buyer to the incumbent). This is the actual regime endorsed by the European Directive;

(iii) the adjusted MBR regime, in which the price offered by the buyer to the non-controlling shareholders is “adjusted”, which means that some discrimination is allowed between the per share price offered to the non-controlling shareholders and that paid to the incumbent. (In most of the cases, this “discrimination” between the two prices has the practical effect of allowing the bid to be made at a discount with respect to the price paid for acquiring the controlling block.) This is currently the case, for instance, of the Italian and Austrian legislations. 89

2.1. The Parties’ Efficient Condition of Exchange

In private sales of control, the incumbent controller and the buyer set the price in accordance with (i) the share value under (the management of) the incumbent (buyer); and (ii) the net present value of the DPB for the incumbent (buyer). The exchange price of the controlling block will depend on the value of these two assets and their weight in the block.

Consider this simple model. Let \( S \) be the incumbent controller of a publicly held company, \( B \) the prospective buyer, \( \phi \) the number of shares owned by \( S \), and \( n \) the number of the company’s outstanding shares. Further let \( x_s \) be the per share value under the

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89 See supra note 65.
management of $S$, $Y_S$ the DPB extracted by $S$, and $y_S$ the per share value of the DPB extracted by $S$ where $y_S = Y_S / \phi$.  

Symmetrically, let $x_B$ and $y_B$ be, respectively, the per share value under the management of $B$ and the per share value of the DPB that $B$ will extract if she gains control. 

The wealth of $S$ in holding one share of the controlling block, $w_S$, is thus equal to $w_S = x_S + y_S$. The respective wealth of $B$, $w_B$, is equal to $w_B = x_B + y_B$. Finally, is useful to define $\Delta x = x_B - x_S$; $\Delta y = y_B - y_S$; and $\Delta w = w_B - w_S$.

Rational parties will exchange control when $\Delta w > 0$. In a private sale, there are, then, three conditions of efficient exchange:

(1) when $\Delta x > 0$, and $\Delta y > 0$; or

(2) when $\Delta x > 0$, and $\Delta y < 0$, provided that $|\Delta x| > |\Delta y|$; or

(3) when $\Delta x < 0$, and $\Delta y > 0$, provided that $|\Delta x| < |\Delta y|$.

In the first and second case, the increase of the company’s cash-flows under the management of $B$ makes the transaction efficient both for the parties and society as a whole, including the non-controlling shareholders. In the first case, $B$ increases both the company share value and the size of the DPB. In fact, at least on a theoretical level, 

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90 DPB subtract value from the firm cash-flows to the detriment of the non-controlling shareholders. Thus, should $S$ not have extracted the DPB, the per share value under her management would have been $x'_S = [x_S + (Y_S / n)]$.

91 In the analysis, I do not consider the NDPB that both $B$ and $S$ may be able to extract from the controlling block. Given the idiosyncratic nature of most NDPB, they are unlikely to be part of the exchange. See supra text accompanying note 13.

92 Even though the controlling shareholder increases the DPB, the non-controlling shareholders are not necessarily worse-off. This may be the case, for instance, if the buyer increases the firm’s cash-flows and, at the same time, the absolute (and/or the relative) size of the DPB. For instance, suppose the firm’s cash-flows are 100 under the seller’s management. The seller allocates the cash-flows as follows: 80 as
better management and extraction of higher DPB are not mutually exclusive. In the second case, \( B \) increases the company share value and decreases the size of the DPB. In such a case, then, part of the increase of the share value is due to the DPB reduction.

In the third case, instead, the transaction is efficient for the parties, but may be welfare-decreasing. Indeed, in a sale of control transaction, it may well happen that (i) the value of the higher DPB extracted by \( B \) is greater than the increase of the cash-flows under her management; (ii) the cash-flows under the management of \( B \) are reduced, but the value of the DPB that she extracts is increased. In the latter case, the efficient condition for the parties’ exchange is that the increased value of the DPB is higher than the share value reduction of the controlling block. Under (i), notwithstanding the non-controlling shareholders are worse-off, the sale of control is still welfare-enhancing due to the increase of the cash-flows under the management of \( B \). (Put differently, the transaction is welfare-decreasing only for the non-controlling shareholders.) Under (ii), however, also society as a whole is worse-off after the sale of control. Ultimately, the parties’ exchange is welfare-decreasing (i.e., “socially inefficient”) only when \( \Delta x < 0 \), provided that \( |(n - \phi)\Delta x| > |\phi\Delta w| \).

2.2. The Cost of Private Sales of Corporate Control under Different Regulatory Regimes

The following analysis illustrates how the efficient conditions of the parties’ exchange vary depending on the underlying regulatory regime. In discussing the different regimes, I assume that (i) \( S \) and \( B \) have the same bargaining power and are equally risk adverse, which looks like a plausible assumption in the context of market-based share value, and 20 as DPB. Under the buyer’s management the cash-flows will be 120 and she will allocate them as follows: 90 as share value, and 30 as DPB. In such a case, the buyer has increased both the absolute size (from 20 to 30) and the relative size (from 25% to 33.33%). Society, however, is better off.

\(^{93}\) In the same terms, Barclay & Holderness, supra note 5, at 269.
transactions for the acquisition of a publicly held corporation’s controlling interest; and (ii) the liquidity cost is increasing in the total purchase price to be paid by \( B \). This means that, under a MBR regime, where \( B \) is forced to offer the same price paid to the \( S \) to all shareholders, the cost of raising additional capital increases. Finally, to simplify the analysis, I assume that (iii) the legal costs for the acquisition are trivial.

**(i) The Market Regime**

In a market regime, \( \Delta w > 0 \) is the efficient condition for the parties’ exchange. In turn, a sale of control will take place when \( x_B + y_B - c > x_S + y_S \) where \( c \) are the per share liquidity cost. Since the parties have the same bargaining power, they will share the contractual surplus. Thus, the per share price, \( p_{MB} \), paid by \( B \) to \( S \) will be \( (x_B + y_B - c + x_S + y_S) \)/2. The total cost borne by the buyer is, thus, \( \phi p_{MB} \). Finally, it is worth observing that, under such a regime, the liquidity commitment of \( B \) will be computed on the exclusive basis of the controlling block’s total purchase price.

**(ii) The MBR Regime**

Under the MBR regime, \( B \) must offer the latest highest price paid for the company share (which is, presumably, the price she has paid to \( S \)) to all the company shareholders. Hence, the efficient condition of exchange, \( \Delta w > 0 \), no longer holds true in all cases. Under the MBR regime, a sale of control will take place only when \( x_B + y_B - c \geq x_S + y_S \left( n/\phi \right) \). This means that, in contrast to the market regime, when \( \Delta x < 0, \Delta y > 0 \) (provided that \( \left| (n - \phi) \Delta x \right| > \left| \phi \Delta w \right| \)), a sale of control under the MBR regime will no occur.

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94 Cf. Burkart & Panunzi, *supra* note 66, at 752 (observing that “the per-share takeover costs are larger in a full acquisition because, e.g., the higher financing need increases the (marginal) borrowing cost.”)
The MBR regime modifies B’s efficient condition of exchange by imposing her to pay to all the non-controlling shareholders (that will tender) the same premium she pays for the DPB extractable by the controlling block. Practically, the MBR multiplies the “DPB premium” that B has to pay (to S) for gaining control of the company.\(^95\) This, in turn, will increase B’s liquidity cost,\(^96\) since “prudent buyers” always expect that almost all the non-controlling shareholders will tender,\(^97\) and, ultimately, reduce \(w_B\).

A simple example may prove useful to better clarify the different efficient conditions for the parties’ exchange under the market and the MBR regime.\(^98\) Imagine a corporation with 100 shares, and a controlling shareholder holding a 40% block. The per share value under the incumbent controller is $10. The value of the DPB extracted by the incumbent is $120. Hence, the total value of the incumbent’s block is $520, and its per share value is $13. Under the market regime, the transfer of control will take place when

\[ x_B + y_B - c > x_S + y_S + N\left( y_S \right) \left[ y_S \left( \frac{n - \phi}{\phi} \right) \right], \]

where \( N\left( y_S \right) \in [0,1] \) and \( N'\left( y_S \right) > 0 \). Empirical evidence confirms that \( N\left( y_S \right) \) is essentially a function of the size of the DPB. This means that, when \( y_S \) is very high, \( N \) approaches to 1.

\(^95\) The actual multiplier effect over the DPB premium determined by the MBR will depend on the percentage of the non-controlling shareholders that will tender. The higher such a percentage, the higher the multiplier effect of the MBR. From this perspective, letting \( N\left( y_s \right) \) be the percentage of non-controlling shareholders that will tender, the above-described efficient condition of the parties’ exchange under the MBR regime can be rewritten as follows: \( x_B + y_B - c > x_S + y_S + N\left( y_S \right) \left[ y_S \left( \frac{n - \phi}{\phi} \right) \right], \)

\(^96\) Considering that \( N\left( y_S \right) \) is increasing in the size of the DPB, the liquidity cost borne by the buyer under the MBR can be expressed as \( c \left( y_S \right) \), where \( c' > 0 \).


\(^98\) To make things simpler, both in this and the following examples, I do not consider the liquidity costs of the transaction.
the buyer expects that the per share value of the controlling block under her management will be higher than $13. This would be the case, for instance, when the buyer expects to be able to extract the same DPB of the seller-incumbent ($120) and to increase the share value of $1. In such a case, the expected per share welfare of the buyer would be $14. Accordingly, she would set her reservation price for the purchase of the controlling block at $560. The transfer of control would be profitable for both parties and the deal would, therefore, be implemented.

Under the MBR regime, instead, the buyer is forced to offer the per share price that she pays to the seller, let say $13 (assuming that the seller accepts to sale the controlling block at her reservation price), also to the non-controlling shareholders. In turn, assuming that all the non-controlling shareholders accept the buyer’s offer, the DPB control premium that the latter would end up paying would be equal to $300 ($120 to be paid to the seller plus $180 to be paid to the non-controlling shareholders). This means that, to be able to extract the same DPB of the seller, the buyer should increase the corporate cash-flows of at least $180. This would not be possible where she expects to increase the per share value of just $1. Under the MBR regime, to acquire control of the company, the buyer would end up paying a total purchase price of $1,300 (assuming, as said, that all the non-controlling shareholders tender), while the utility that she would gain from the company’s control would be equal to $1,220 ($1,100 in share value plus $120 in DPB). Put differently, the buyer’s expected per share welfare, under the MBR regime, drops from $14 to $12.2, with a total loss of $80. Following the logic of the example, all the potential sales of control in which the buyers expects to increase the per share price from $10 to $11.8 are screened out by the MBR.

(iii) The Adjusted MBR Regime

Under the adjusted MBR regime, some discrimination is allowed between the per share price that the buyer must offer to the non-controlling shareholders and the price she
pays to the incumbent controller. This is the case, for instance, of the mechanic of price determination provided for by the Italian legislation, in which the offer’s price must be equal to the arithmetic mean between the latest highest price paid for the company shares (presumably, the price paid to the incumbent) and the average market price of the shares in the last 12 months. Under the Italian legislation, then, letting \( p_M \) be the average market price of the company shares in the last 12 months, the efficient condition for the parties’ exchange is

\[
x_B + y_B \geq \left( x_s + y_s \right) \left( \phi / n \right) + \left( \frac{x_s + y_s + p_M}{2} \right) \left( \frac{n - \phi}{n} \right).
\]

It is, then, intuitive that, for low \( p_M \), the multiplier effect of the (adjusted) MBR over the DPB premium is reduced. The offer’s price will, indeed, tend to be lower than the one the buyer should pay under a strict MBR regime. By contrast, for high \( p_M \), the multiplier effect of the (adjusted) MBR may virtually increase.\(^{100}\)

\(^{99}\) Also in this case the multiplier effect of the MBR must be weighted for the percentage of non-controlling shareholders that will tender. Under the MBR adjusted regime, such a percentage is increasing in the size of the seller’s DPB and in \( p_M \). Thus, we can rewrite the efficient condition of exchange inequality under the adjusted MBR as

\[
x_B + y_B \geq \left( x_s + y_s \right) \left( \phi / n \right) + N \left( y_s, p_M \right) \left( \frac{x_s + y_s + p_M}{2} \right) \left( \frac{n - \phi}{n} \right),
\]

where \( N \left( y_s, p_M \right) \in [0,1] \). Therefore, the price-limit the buyer is willing to pay to the seller is:

\[
\left( x_s + y_s \right) \left( \phi / n \right) + \left( \frac{x_s + y_s + p_M}{2} \right) \left( \frac{n - \phi}{n} \right) = w_B.
\]

Solving for \( x_s + y_s = w_s \) we get

\[
w^*_B = \frac{2w_B - p_M \left( \frac{n - \phi}{n} \right)}{1 + \left( \frac{\phi}{n} \right)}.
\]

Finally, the per share control premium that the buyer is willing to pay will be

\[
y^*_s = w^*_s - x_s.
\]

\(^{100}\) Such a circumstance can occur, for instance, when the firm is distressed from a short time ago. Then, \( p_M \) can be higher than the private price agreed between the buyer and the seller.
To clarify the difference with the strict MBR regime, let’s consider the example described above. Should the buyer have offered a per share price of $13, the DPB premium to be paid to the minority shareholders (i.e., 60% of all the outstanding shares) would have been $180, which would have made the deal unprofitable for the buyer. Under the adjusted MBR regime, instead, letting $p_M$ be, for instance, $9, the same deal would be marginally profitable for the buyer. Under such a regime, the total purchase price that the buyer should pay, still assuming that all the minority shareholders accept her offer, would be equal to $1220 ($560 for the controlling block, whose per share value is still $13, plus $660 for the minority shareholders’ stockholdings, whose per share value is $11). In turn, the per share price that the buyer would end up paying would be equal to $12.2, which would be equivalent to her expected per share welfare. This means that, under an adjusted MBR regime, all the potential sales of controls in which the buyers expect to increase the share price from $10 to $11 would still take place.  

3. Discussion

The foregoing analysis offers several topics of discussion. As noted above, the arguments adduced in favor of the MBR are, basically, two. One is based on the distributive-concerned claim that the MBR prevents the expropriation of minority shareholder value from opportunist buyers, whose principal expectation in seeking control of the company is the extraction of high DPB. The other, instead, is grounded on the allocative-efficiency claim that the MBR, by enhancing the minority share value, lower the corporation’s cost for raising equity capital and, in turn, promote more effective corporate structures.

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101 In Italy, the adjusted price mechanism has in fact made possible a few transfers of control that would have otherwise never occurred. See Mario Massari, Vittorio Monge, & Laura Zanetti, supra note 97, at 28-31

102 See supra Par. 2.1.
For such arguments to hold, however, the following considerations need to be plausible. First, it should be likely that, absent the MBR, a significant number of transfers of control to opportunistic buyers would take place. Second, it should be likely that the minority shareholders’ loss of welfare would be higher than the increase of the buyer’s welfare (i.e., inefficient transaction test). Third, the social loss under the market rule should be higher than that under the MBR. In other words, the aggregate value of the inefficient transactions that the MBR deters should be higher than that of the efficient sales of control that would occur in its absence (i.e., social costs test).

I argue that such prepositions are unlikely to be true. First, it is unlikely that prospective buyers may extract higher DPB than incumbent controllers. I claim, indeed, that the DPB that a controlling blockholder can extract are determined by the legal environment, the kind of industry, and the level of market competition of the country in which the controlled company is chartered. In turn, the risk of transfers of control that expropriate minority value would be relatively low, since it seems implausible that a large number of prospective buyers will be moved just by opportunistic reasons in seeking control of the company. The latter claim finds additional support if the relatively high level of concentration that characterizes corporate ownership in most European Continental countries is taken into consideration. Given such an ownership pattern, should the buyer expropriate share value by extracting high DPB, she would internalize great part of the share value loss. It follows from the foregoing that the number of transactions in which the inefficient transaction test is satisfied will tend to be relatively indifferent.

Second, it is improbable that, in Europe, the aggregate value of inefficient transactions that the MBR deters is higher than that of the efficient transfers that the rule prevents. On the one side, as just observed, the number of inefficient transactions would tend to be relatively low in Europe. On the other, the number of value-increasing sales of
control that the MBR prevents is increasing in the size of the DPB. In turn, being the average DPB size in Continental Europe relatively large, the MBR is likely to prevent a high number of value-increasing transactions.

3.1. Determinants of DPB Size

The MBR regime makes impossible (i.e., unprofitable) a sale of control when $|\phi w| < |(n-\phi)x|$. The justification of this restriction rests on the assumption that $\Delta y > 0$ or, put differently, that the extraction of DPB depends on the nature of the controlling blockholder. “Bad controllers” would expropriate minority shareholder value by extracting high DPB. From this perspective, the MBR is the legal tool which prevents bad (or, at least, worse) controllers from gaining control of the company.

Yet, the above is a misleading representation. Indeed, the size of DPB that a controlling blockholder is able to extract depends on the legal environment, the kind of industry, and the level of competition of the country where the target is chartered.

As a matter of legal theory, the extraction of DPB is, basically, a violation of corporate fiduciary duties.\(^{103}\) Wasting corporate resources in excessive managerial perquisites, diverting corporate opportunities, engaging in self-dealing, etc., are all conducts in breach of such duties. In turn, the extraction of DPB will depend on the effectiveness of the legal system’s rules and quality of law enforcement, rather than of

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\(^{103}\) Corporate fiduciaries duties include both the duties owe by directors to the corporation and those owed by majority toward minority shareholders. On the matter, see, among others, Gilson & Gordon, supra note 12, at 789-90 (analyzing the duties of the blockholder toward non-controlling shareholders as established in Sinclair Oil v. Levien (280 A.2d 717 (Del. 1971))). See also Barclay & Holner, supra notes, 10, 44.
the “evil nature” of the controlling blockholder. This is confirmed by empirical evidence showing that DPB tend to be higher in countries where the fiduciary and disclosure standards imposed on controlling shareholders are lax. On the contrary, DPB tend to be low where the legal system ensures speedy and predictable enforcement of minority shareholders’ suits against controlling shareholders.

It is as well confirmed by empirical evidence that the size of DPB vary across industries. It seems, then, reasonable to infer that DPB are a function not only of the legal norms that govern the corporate entity’s existence, but of social norms as well. Finally, the controller’s ability to extract DPB is directly related to the competitive level of the market in which she operates. Reputational capital’s value, in fact, increases in highly competitive market.

For these reasons, the concern of the European legislator that a common playfield of European buyers and sellers may increase the risk of minority expropriation from “bad controllers” seems unjustified. It is, indeed, very unlikely that a buyer coming from a

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Is not striking how little confidence the European legal systems have in the business acumen of their enterprise leaders? Europe’s legal order prefers to step in to prevent presumptive ill use of corporate assets, rather than providing efficient means for curbing such ill use after it has effectively occurred. More generally, this fear of looting corresponds to a presumption of bad faith, a reasoning contrary to the legal tradition.

105 Sources: Dyck & Zingales, supra note 7, at 576; La Porta, Investor Protection, supra note 31; La Porta, Law & Finance, supra note 31. See also Luigi Zingales, What Determines the Value of Corporate Votes, 110 QUART. J. ECON. 1047, 1071-2.

106 Id.

107 For instance, the extraction of DPB is substantial in professional sport clubs, entertainment, and mass media. See Demsetz & Lehn, supra note 11, passim.
country where the size of DPB is relatively high may be able to extract the same DPB from a company chartered in a country where the size of DPB is relatively low. On the contrary, since the legal, social, and reputational sanctions that the buyer and the incumbent face in a particular country are the same, it is much more likely that the buyer will extract the same DPB of the incumbent, or formally that $\Delta y = 0$. Assuming equally risk adverse parties, both the incumbent and the buyer will, in fact, extract DPB up to the point where the expected cost of the sanctions exceeds the DPB value.\(^{108}\) Hence, it seems plausible to conclude that prospective buyers will be more likely motivated to seek control for increasing the company share value rather than extracting higher DPB. Accordingly, all parties, minority shareholders included, would be better off absent the MBR.

Such considerations find support in empirical data showing that in those countries where the MBR is absent, like the United States, large blocks’ trade are on average associated with abnormal share value increase.\(^{109}\) Similarly, in Europe, the empirical evidence (relating to the situation preceding the adoption of the European Directive) highlights the existence of abnormal returns both for private sales of controlling blocks below the national control threshold and sales occurred before the adoption by the single Member State of an MBR provision.\(^{110}\) These empirical findings seem, thus, to confirm the suggestion that improved management rather than extraction of DPB is the principal source of gains in sale-of-control transactions.\(^{111}\)

\(^{108}\) See Steven Shavell, Foundation of Economic Analysis of Law 479 (2004).

\(^{109}\) Source: Holderness, supra note 10, *passim*.

\(^{110}\) Sources: UBS (Giuseppe Pannizzardi), and Dresdner Kleinwort Wasserstein (Vittorio Perona, and David Hutchinson).

\(^{111}\) Berglöf & Burkart, *supra* note 11, at 197-198; Burkart & Panunzi, *supra* note 66, at 761.
3.2. The MBR and the Size of DPB

The foregoing discussion explains why it is unlikely that a significant number of transfers of control resulting in the expropriation of minority shareholders will occur. This means that the aggregate value of inefficient transactions will tend to be relatively low. To claim that MBR does not satisfy the social cost test, however, it is necessary to verify that the rule also prevents a large number of value-increasing transactions from taking place.

As clarified above, the MBR decreases the number of efficient transfers of control because it makes the buyer’s condition for a profitable exchange more demanding. Under the rule regime, the buyer ends up paying a multiple of the DPB premium she must pay to the incumbent. In turn, as the DPB size increases, the buyer’s (expected) welfare from the acquisition of control decreases, and so does the probability that the transaction will take place. In addition, the multiplier effect of the MBR over the DPB control premium increases the total purchase price the buyer must pay to gain control and, therefore, her liquidity costs.113

112 See supra Par. 2.2.2.(i)

113 The actual increase of the total costs of the buyer at the increase of the DPB size will be determined by the percentage of the non-controlling shareholders that will tender. Thus, from the efficient condition of the parties’ exchange under the MBR (see supra note 92),

\[ x_B + y_B - c > x_S + y_S + N(y_S) \left[ y_S \left( \frac{\theta - \phi}{\phi} \right) \right], \]

setting the per share welfare of the buyer equal to the second term,

\[ w_B = x_S + y_S + N(y_S) \left[ y_S \left( \frac{\theta - \phi}{\phi} \right) \right] + c(y_S, \phi), \]

and differentiating \( w_B \) with respect to \( y_S \), we get

\[
\frac{\partial w_B}{\partial y_S} = 1 + \frac{\partial N}{\partial y_S} \left[ y_S \left( \frac{\theta - \phi}{\phi} \right) \right] + N(y_S) \left( \frac{\theta - \phi}{\phi} \right) \frac{\partial c}{\partial y_S},
\]

which tells us how much, keeping the other variables constant, the per share welfare of the buyer has to increase, at the increase of the per share value of the DPB of the seller, to make the transfer profitable.
This implies that in Continental Europe, where DPB tends to be high, the MBR, by decreasing the buyer’s (expected) welfare substantially, prevents a large number of welfare-increasing corporate acquisitions from taking place. It can, then, be concluded that the European MBR:

(i) does not satisfy the social cost test;

(ii) goes in a direction opposite to the declared goal of the Takeover Directive of promoting the development of the European market for corporate control and the transformation of the European industrial structure. The paradox of the MBR is that, in the attempt of screening out “bad controllers”, it ends up preventing managerial turnover where the latter is most needed, that is, where the incumbent controller extracts high DPB;

(iii) jeopardizes, rather than enhancing, corporate efficiency. Indeed, the claim that the enhanced protection of non-controlling shareholders results in a lower cost of equity capital must be rebutted for two reasons. First, as just observed, the MBR fails to protect minority shareholders against the extraction of high DPB. Second, by decreasing the probability of efficient control transfers,114 the MBR reduces the value of the firm, which is the sum of its status quo value and the expected value of any future improvement deriving from efficient transfers of control.115 Ultimately, the MBR makes the same minority shareholders worse-off.116

114 Indeed, the MBR is likely to frustrate even the gathering of information on potential acquisitions. See Schwartz, supra note 45, at 249. See also Bergström, Högfeldt, & Molin, supra note 12, at 448.

115 Bergström & Högfeldt, supra note 87, at 384.

116 Formally, (i) the firm’s value, \( V \), is increasing in the frequency of a control transfer; (ii) the frequency of a control transfer is decreasing in \( \Delta w \); and (iii) \( \Delta w \), under the MBR regime, is decreasing in
3.3. Why the MBR May Lead to Further Ownership Concentration

There is a final compelling argument against the European MBR. When corporate ownership is concentrated and the DPB extracted by the incumbent tend to be relatively high, as it is the case in Continental Europe, launching a hostile takeover may constitute a less onerous way to acquire control of the company. Hence, the MBR may induce incumbents to increase the concentration of their controlling interest in order to prevent the occurrence of a hostile takeover. This, in turn, will reduce control contestability and, ultimately, the firm’s value.

When the incumbent’s controlling interest in the company is relatively large, but still contestable,\(^\text{117}\) and the DPB extracted by the incumbent are high, the total purchase price to be paid by the buyer for gaining control of the company through a hostile bid may well be lower than that to be paid in a friendly takeover under the MBR regime. In the latter case, the buyer must offer the DPB premium also to all the non-controlling shareholders. In a hostile bid, instead, the offer price is set on the basis of market-based evaluations, and the buyer is not obliged to offer the DPB premium.\(^\text{118}\)

Consider the following example. Let’s assume that the controlling blockholder of company X, which has 100 outstanding shares, holds a block equal to 25%. The residual 75% of the shares is dispersed. The share market price under the incumbent controller is the size of the incumbent’s DPB, \(y_s\). Finally, while in a market regime, \(V\) is not influenced by the DPB size; under the MBR regime, \(V\) is decreasing in the size of the incumbent’s DPB: \(V(y_s)\) where \(V' < 0\).

\(^{117}\) By “contestable”, I mean that \(\phi < n / 2\) is not a sufficient condition. In order to be effectively contestable, \(\phi\) should be sensibly lower than \(\phi < n / 2\). In fact, when the controlling block is slightly below 50% of the voting rights, it is unlikely that the company can be the object of a hostile takeover. See John C. Coates, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, ECG Working Paper No., 22. 11/2003.

\(^{118}\) See *supra* text at note 6.
equal to $10. Further assume that a prospective buyer wants to gain control of X. To achieve this goal, she can adopt two different strategies.

1. The first strategy is the friendly acquisition of the control block from the incumbent. Let’s assume that the per share value of the block for the incumbent is $12. Let’s further assume that the buyer expects to (i) increase the per share value of the company from $10 to $11; and (ii) extract the same DPB of the incumbent (i.e., $50). Hence, for the buyer, the controlling block has a total value of $325, and a per share value of $13.

   In turn, under a market regime, if the buyer gains control of the company, the social welfare is increased of 10%. Under a MBR regime, however, the same deal is no longer profitable for the buyer. In such a case, after having acquired the controlling block from the seller, the buyer would have to tender offer at the same price to all the non-controlling shareholders. Even assuming that the incumbent has transferred the controlling block at her reservation price, $12, the MBR would still make the deal unprofitable. The total costs of acquisition would be equal to $1,200; while, for the buyer, the company has a total value of $1,150.

2. The second strategy is seeking to gain control of the company through a hostile bid. In such a case, the buyer would be willing to offer up to $11.7 per share, i.e., her reservation price for the acquisition of the controlling block from the incumbent. (Although, in practice, the buyer will usually offer a price that is lower than her reservation price). It is, thus, likely that the buyer will be able to get control over the company. In such an event, however, the incumbent would lose her DPB without being compensated for. Therefore, a rational incumbent will most likely attempt to prevent the buyer’s takeover by consolidating her controlling interest. In practice, the incumbent will counter offer up to the value of her DPB control premium. However, because her break-
even price is $10.75,\textsuperscript{119} the tender offer of the incumbent cannot compete with that of the buyer. The incumbent will lose control of X and also her DPB.

This simple example offers an important insight on the effects that the adoption of the MBR provision is likely to produce in (Continental) Europe. In those countries where corporate ownership tends to be concentrated and DPB tend to be high, it seems plausible that incumbents will seek to consolidate their controlling interests in order to prevent the “expropriation” of their DPB by a hostile bidder.\textsuperscript{120} It is, instead, unlikely that the MBR should lead to an overall reduction of the DPB, as claimed by someone. By hindering the DPB private sale, the MBR would make their extraction unprofitable.\textsuperscript{121} This looks like an overoptimistic view, however. If the incumbent cannot extract the DPB by selling her block at a premium that reflects their capitalized value, she will seek to secure the DPB that arise from operating the company.\textsuperscript{122}

\textsuperscript{119} The incumbent will be willing to offer to the non-controlling shareholders up to $10.75 = $10 + ($50 / 75). Indeed, should she be able to retain control of the company by offering such a price, control would still be marginally profitable for her due to the existence of NDPB.

\textsuperscript{120} This prediction is consistent with the analysis of Lucian A. Bebchuk, \textit{A Rent Protection Theory of Corporate Ownership and Control}, NBER Working Paper No. 7203, 15, 37 (1999).

\textsuperscript{121} The rebuttal of such an “intuition” would find support in the empirical evidence. For instance, in Sweden and Netherlands, which have not yet adopted a MBR provision, the DPB premium counts for just, respectively, the 7%, and the 2% of the purchase price. By contrast, in some of the countries that have adopted the MBR, such as Italy, Austria, and Portugal, the average DPB premium counts for, respectively, the 37%, 38% and 20% of the purchase price. Sources: Dyck & Zingales, \textit{supra} note 7, at 551.

\textsuperscript{122} See Gilson & Gordon, \textit{supra} notes 12, 20.
PART III

POLICY CONSIDERATIONS

1. The Protection of Minority Shareholders

The foregoing analysis has illustrated why the mix of distributive and allocative objects of the European MBR is likely to produce inefficient results, that is, fail to boost the much needed restructuring of the European capital market. The consideration of equality and fairness underpinning the adoption of the rule turn out being more detrimental than beneficial for the same minority shareholders, to whom such considerations are primarily addressed. It is, then, legitimate to question whether alternative legal, or extralegal, tools would not have been more efficient to secure minority shareholder interests.

I claim that a better way for protecting minority shareholders is the implementation of legal rules designed to reduce the size of the DPB extracted by controlling blockholders. If the object is preventing the expropriation of minority value, it makes little sense to impose a rule, which prevents the sale, but not the extraction, of DPB. The promotion of effective managerial fiduciary duties and disclosure obligations, high-quality accounting rules, efficient law enforcement, etc., proves a much better way to protect minorities and avoid value-decreasing transfers of control than the adoption of a MBR provision. An approach like the American one, which focuses primarily on preventing the extraction of DPB by the incumbent and admits rare exceptions to the free transferability of control, would have been desirable in Europe. Such an approach would have ensured minority protection without frustrating the market for corporate control.

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These considerations find support in empirical evidence showing the different DPB size across the world. The data confirm that, regardless of the adoption of a MBR provision, in countries where the quality of legal rules and law enforcement is high, DPB tend to be low. This is the case, for instance, in Germany, Sweden, and the Netherlands, besides the United States. (It is worth observing that only Germany, among these countries, has adopted an MBR provision.) On the contrary, where legal rules and law enforcement are not very effective, DPB tend to be high. Consider, for example, Italy, where DPB measure (on average) 37%. Italian legal rules on fiduciary duties are unclear. Their scope tends to be re-determined from time to time by courts’ idiosyncratic decisions. Independent directors are rare and, in the few cases in which they sit on the board, they tend not to be very “independent”. Minority shareholders’ legal suits are discouraged by legal and bureaucratic difficulties. On average, a corporate lawsuit lasts 10 years before reaching a final decision. Still, Italy has adopted the MBR regime. Has this proved helpful to protect Italian minority shareholders? Looking at the average size of the DPB extracted by Italian controllers, the answer is: no.

124 Source: Dyck & Zingales, supra note 7, at 551.

125 The size of DPB in these countries is, respectively, 10%, 2%, 2%, and 1%. Id.

126 Id. In Brasil, for instance, DPB measure 65%.

127 The shortcomings of Italian legal systems have been discussed by, among others, Luca Enriques, Off the Books, but on the Record: Evidence from Italy on the Relevance of Judges to the Quality of Corporate Law, in GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS; Jonathan R. Macey, Corporate Governance in Italy: One American’s Perspective, 1998 COL. BUS. L. REV. 121. See also, Magda Bianco & Paola Casavola, Italian Corporate Governance: Effects on Financial Structure and Firm Performance, 43 EUROPEAN ECONOMIC REVIEW 1057 (1999).
For these reasons, promoting better national rules and monitoring the quality of law enforcement across Europe would have been a better way to foster the development of the European capital market. The European MBR, instead, not only does not go in this direction, but eliminates the competitive pressure among Member States, which could have been beneficial to improve poor national legal rules. In addition, competition increases the value of reputational capital, which may well be another instrument to prevent DPB extraction. This is confirmed by empirical evidence. In countries characterized by low level of competition—like, for instance, Italy, Austria, and Portugal—the extraction of DPB proves substantial; on the contrary, where markets are more competitive—like in the case of Sweden and the Netherlands—DPB tend to be relatively low. Thus, by hindering competition, the MBR is also likely to decrease the effectiveness of reputational sanctions in preventing the extraction of DPB.

Still, one final consideration is due on minority protection. The European legislator seems to neglect a basic instrument that minority shareholders, who often are institutional investors, use to protect their corporate interests: the acquisition of diversified portfolios. Diversified investors want to maximize the value of their portfolios, which consists of shares both in prospective target companies and bidding firms, and not just the value of a particular stock. From this perspective, the MBR makes investors worse off two times: a first one, as shareholders of the bidder, since it reduces the latter’s expected welfare arising from the transfer of control; a second, as shareholders of the target, since it leaves incumbents free to keep on extracting DPB.128

128 In similar terms, see Bergström & Högfeldt, supra note 87, at 391-92; Lan Luh Luh, Ho Yew Kee, & Ng See Leng, Mandatory Bid Rule: Impact of Control Threshold on Take-Over Premiums, 2001 SING. J. LEGAL STUD. 433, 436.
2. The MBR and the Control Threshold

The picture drawn above on the likely effects that the MBR will produce over the European capital market is a rather discouraging one. Still, there might be a way to improve the status quo. As previously discussed, control thresholds have a great impact on the level of free transfers of control. Then, it is worth attempting to devise which criteria should be followed for setting control thresholds in Europe in order to reduce the negative impact of the MBR.

The European Directive’s provisions on the control threshold are not very clear. At first sight, the Directive seems to endorse a bright-line approach for setting the threshold. Article 5 provides that the European MBR is triggered when “a specified percentage of voting rights”, to be “freely” determined by each Member States, is acquired. At a second look, however, the Directive seems to promote a “working control” approach as to the determination of the threshold. Article 5 also provides, indeed, that the specific percentage of voting rights triggering the MBR should be that “giving [the prospective buyer] control of … [the] company.” From this perspective, Member States would, thus, be required to set control thresholds at a level which reflects the voting rights percentage that is actually needed to acquire control of a corporation in the different countries.

The uncertain wording of Article 5 is probably due to the attempt of reaching a compromise among the discordant positions of Member States on control threshold policies. The difference between one approach and the other is substantial. Under the bright-line approach, Member States have free reins in determining the level of transfers of control which can still take place. If they want to allow more free transfers, they will simply need to set the control threshold at a level higher than the median controlling

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129 See supra text accompanying notes 62, 63.

130 See supra text accompanying notes 62, 63.
block. On the contrary, the working control approach does not allow any flexibility. Under this approach, in fact, the threshold must be set at a level which potentially catches all transfers of control, i.e. at a level which is substantially lower than the median controlling block.

From the above, it seems more likely that the European regulator will work to implement the working control approach. The bright line approach would, in fact, risks frustrating the MBR logic altogether. Still, from an efficiency perspective, the second approach seems more desirable to mitigate the effect of the MBR. Indeed, higher thresholds imply two consequences. First, they allow a larger number of free transfers of control. Second, they permit prospective buyers to accumulate more shares on the market before the MBR being triggered (i.e., allow larger toeholds), with the results of lowering the costs of acquisition. The following hypotheses illustrate the potential strategies that prospective buyers could adopt on the basis of the threshold level.

Consider first the case in which the national mean controlling block is equal to $\phi \leq n/2$, and the threshold, $t$, is $t \geq \phi$ (i.e., the English case). In this case, the bulk of the transfers of corporate control will take place without the MBR being triggered. Practically, the MBR will have no effect; therefore, no strategy-issues are likely to arise.

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131 The toehold is the maximum limit of shares (i.e., voting rights) that the potential buyer can accumulate in the market before the MBR is triggered. See Jeremy Bulow, Ming Huang & Paul Klemper, Toeholds and Takeovers, 107 J. POL. ECON. 427 (1999) (defining the toehold as “the substantial stake held by a potential bidder before making a bid for the target firm.”)

132 In the UK, the median controlling block is 9.9 %, and the control threshold is set at 30%. Source: see supra note 63.
Things, however, will be different when the controlling block is equal to $\phi \leq n/2$, and the threshold is $t \leq \phi$ (the Spanish case).\textsuperscript{133} In such circumstances, for a prospective buyer is less expensive to accumulate the toehold (and then launch a hostile bid) than acquire control from the incumbent. As above illustrated,\textsuperscript{134} however, it is very unlikely that, when the DPB are high, the incumbent will leave free reins to the buyer. Instead, she will attempt to consolidate her control interest. Still, it cannot be excluded that the incumbent and the buyer will reach an agreement, before the buyer starts accumulating shares on the market, and play “together” around the rule.

Finally, consider the case in which the controlling block is equal to $\phi \geq n/2$, and the threshold is $t \leq \phi$ (the Italian case).\textsuperscript{135} In such circumstances, the buyer cannot gain control of the company without acquiring the control block. Still, if the incumbent and the buyer are able to find an agreement, there is still a strategy for reducing the costs of acquisition. The buyer should first accumulate the toehold, and, then, acquire the controlling block from the seller. In such a way, the buyer should offer the DPB premium she pays to the incumbent only to the residual non-controlling shareholders, $k = n - t - \phi$. Thus, letting $x_s$ be the market per share price under the seller’s control, and $w_s$ the per share price paid by the buyer to the incumbent where $w_s > x_s$, the total cost of the acquisition are $tx_s + \phi w_s + kw_s$, which simplifies in $tx_s + (n - t)w_s$. The buyer will save $t(w_s - x_s) = ty_s$.\textsuperscript{136} Finally, by accumulating the toehold, the buyer is able to dilute

\textsuperscript{133} In Spain, the median controlling block is 34.5 %, and the control threshold is set at 25%. Source: Crespi-Cladera & Garcia-Cestona, supra note 64.

\textsuperscript{134} See supra Par. 2.3.3.

\textsuperscript{135} See supra note 28.

\textsuperscript{136} This result is consistent with Luh, Kee, & Leng, supra note 128, at 445.
the multiplier effect of the MBR over the DPB control premium. Although the MBR logic would be partially frustrated, since the non-controlling shareholders that sell their shares to the buyer before she reaches the toehold are penalized, the strategy would prove efficient the reduce the costs of acquisition. Still, the buyer’s ability to accumulate the toehold, however, will depend on the effectiveness of the disclosure laws imposed by each country.\textsuperscript{137} It seems, indeed, unlikely that when strict disclosure provisions are imposed on investors as to the accumulation of shares on the market, the latter might be able to play the above-described strategy.

\textbf{Conclusions}

The MBR is an inefficient rule for Europe. This paper has offered several arguments in support of this claim. First, the adoption of a harmonized mandatory approach such as that implemented through the adoption of the MBR is likely to undermine rather than promote the development of a competitive market for corporate control. Second the confusion between distributive and allocative objects underpinning the enactment of the MBR is unlikely to obtain any efficient result. On the one side, the MBR fails to protect minority interests. Indeed, the rule does not prevent the expropriation of private benefits of control. A regulative choice focusing on the enhancement of corporate fiduciary duties and law enforcement would have been much more effective to safeguard minority interests. On the other, the MBR reduces corporate wealth by preventing a large number of value increasing transactions from taking place. Paradoxically, then, such an effect of the rule is increasing in the size of the DPB. Thus, the MBR not only fail to protect minority shareholders when they would most need protection, but makes them worse off decreasing firms’ value. Finally, the rule may lead

\begin{footnote}
\textsuperscript{137} \textit{Id.}, at 448.
\end{footnote}
to further increase in corporate ownership concentration, with the result of decreasing corporate contestability.

In capital markets, regulation grounded on justice considerations rather than strong economic arguments is harmful. The European MBR is unfortunately an example of the first kind.
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