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The battle over the Takeovers Directive

Some recent takeovers have gone badly wrong, and the question of how they can be regulated has produced an unprecedented dispute at European level. With strong opposition to anything that would make takeovers easier, there are few signs of agreement being reached.

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■ In early July 2001, the European Parliament decided, by an extremely narrow majority, to reject a compromise proposal for a Takeovers Directive. This meant that after 12 years of intensive debate, the attempt to create a single set of regulations governing takeovers across the whole of the EU had failed.

The sticking point for a majority of MEPs was Article 9 of the proposed Directive. This stipulated that in the case of hostile takeover bids, shareholders needed to approve in advance any defensive measures by the target company. The only exception allowed would be in the case of a company attempting to find an alternative bidder or 'white knight'. Most of the opponents of the proposal wanted to allow the target company's board to take defensive measures if they had sought shareholders' authorisation not earlier than 18 months before the period of acceptance of the bid. The German trade unions wanted to give the supervisory board (on which employees are represented in accordance with the →

The most spectacular takeover battle in German history lasted for more than three months. When it ended in February 2000, the British mobile phone giant Vodophone had swallowed up the Düsseldorf-based company Mannesmann

photo: dpa

Key questions

Why did the German trade unions oppose the Directive, despite the fact that it provided for regulations allowing employee participation?

Why did UK, Scandinavian and Luxembourg MEPs from all political parties support the Directive almost without exception?

Why did virtually all German, Belgian and Greek MEPs oppose it?

➔ co-determination system) the power to authorise defensive measures. Both measures would have made it easier for companies to defend themselves against hostile takeovers.

In the Council of Ministers, which brings together representatives of the governments of member states, the German government, anxious for Germany to be seen as an investor-friendly business location, initially argued in favour of the duty of board neutrality – in other words, that company directors should take no position on the takeover. It presented a Bill to this effect in March 2001.

While shareholder associations welcomed this Bill, the duty of neutrality was opposed by the main employers' and industry associations, with the backing of the DGB (German Trade Union Federation) and the IG Metall union. The intervention of these associations led to a massive U-turn by the German government. From the end of April 2001, it suddenly started voting against the duty of neutrality, abandoned its support for the Takeovers Directive, and in November of last year passed a national Takeovers Act that allows for prior shareholder authorisation of defensive measures.

Comparison between the UK and Germany

A comparison of the corporate governance systems in different EU countries should enable a better understanding of these developments. In this respect, the most instructive contrast is between the UK and the German systems. The UK system relies on interaction between shareholders and management, based on the assumption that the capital markets will regulate management's actions. In Germany, on the other hand, the capital markets have only a limited role in regulating management.

This is not to say that investors do not affect the direction of corporate policy through their influence on a company's share price. However, there are a number of other important regulators, such as links between companies, 'house banks', the state, and of course, the employee representatives on supervisory boards together with the trade unions.

These differences in the respective systems influence the extent to which a company's policy takes into account the interests of the various stakeholders, the way in which its profits are distributed, and as a result, the company's stock market valuation. The return on sales of large UK companies is approximately twice as high as the average return on sales in Germany. The ratio between the share price and the book value of UK companies is double that of large quoted German companies. In the UK, on average, every euro of the annual turnover of publicly-quoted companies translates in two euros in terms of the company's market value, whereas in Germany, it is worth just 50 cents. The relationship between profitability and market value means that more profitable UK companies have a higher market value than their less profitable German counterparts.

Ultimately, however, none of this means that the shareholders of German quoted companies are any worse off than the shareholders of UK companies, since the figures for price-earnings ratio, return

Different Balances: Selected characteristics of UK and German plcs (average figures for 2000)

UK		Germany
21,5	Price-earnings ratio	17,8
2.6%	Dividend yield	2,7%
20.4%	Return on equity	18.2%
42.337	Market value (mill. €)	20,754
2.14	Ratio of market value to turnover	0.51
0.97	Market value per employee (mill. €)	0.14
4.6	Price - book ratio	2.5
22,015	Turnover	38,122
19.2%	Return on sales (EBIT to sales)	9.4%
60,676	Employees	138,072

Graph: Margret von Conta

Sources:
Europe's 500 journal, Wright Investor's Service.
The figures relate to the 19 largest industrial and commercial plcs in the UK and the 20 largest in Germany. Statistically anomalous figures were not included (price-earnings ratios below zero and over 50).

on equity and dividend yield are similar for both Germany and the UK. The two different systems both guarantee shareholders an appropriate return on their investment and contribute to the successful development of the national economy. Neither model is, or has ever been, better than the other. They are simply two different systems.

Why MEPs voted the way they did

However, in the context of a single market for corporate control where hostile takeovers are possible, the comparison between the respective corporate governance systems looks rather different, since a company's stock market valuation determines how good its prospects are in the mergers and takeovers market. If shares are used as the currency of the takeover, then when a German company is taken over by one from the UK, the market value per employee in the German company is one-sixth that of the UK company. In these circumstances, the issue is no longer that there are two different systems that achieve similar results. Rather, it is clear that where the corporate governance system has led to companies having a high market value, these countries are quite simply stronger in the takeovers market than countries where this is not the case.

This explains why in the July 2001 vote in the European Parliament, MEPs voted along national rather than party-political lines. Approximately 45% of MEPs from the centre-right voted in favour of the Takeovers Directive, while 53% voted against it. Similarly, 50% of socialist MEPs voted for and 50% voted against. However, 86% of MEPs from Sweden, 91% from the UK, and 83% from Ireland and Luxembourg voted in favour of the Directive, whereas 91% of Greek MEPs, 76% from Belgium and 99% from Germany voted against it. This indicates that MEPs voted for or against the Directive on the basis of national interests connected with the stock market valuation of companies in their own countries.

Golden shares and other barriers

The German trade unions welcome the fact that the Directive was not passed. However, this does not mean that German trade unions are in favour of protectionism and they have never argued for legislation to prevent takeovers. On the other hand, they do not believe that the market needs to be further stimulated by a liberal regulatory framework for takeovers.

As well as the low market value of German companies, another key factor is likely to ensure that the takeover of Mannesmann by Vodafone, a major watershed in Germany, does not remain an isolated case. This is the tax exemption for profits where a company sells shares in another company. This tax concession, introduced by the German Finance Minister Hans Eichel, will lead to a reduction in links between companies, making it easier to carry out takeovers. But it will also make it more attractive to break up →

→ the company once it has been taken over, and will increase the potential for takeover arbitrage.

Takeover activity will be further stimulated by the prospect of cashless financing of takeovers by exchanging shares, although this is less likely in today's falling markets. The weak euro has also made it easier for foreign companies to pick up German companies cheaply, although this may also be in the process of changing.

It is also important to recall that many countries have barriers to takeovers that do not exist in Germany (with the exception of Volkswagen, protected by the Volkswagen Act). The UK government, for example, holds 'golden shares', giving it extra rights in several companies, and voting right privileges are also held by the state in The Netherlands, France and Spain, with the French also having maximum voting rights. In the USA, company boards are allowed to take a wide range of defensive measures which vary from state to state, ranging from buying up the bidder's shares or buying back their own shares to selling off the most attractive parts of the business.

In its judgment of June 2002, the European Court of Justice declared state-owned 'golden shares' to be legal only under very restricted conditions. However, if the Commission decides to go down the path of trying to prohibit the prior shareholder authorisation of defensive measures found in Germany but continuing to condone maximum voting rights in other countries, then the German government deserves every support in its opposition to such a policy.

How can German takeover targets be protected?

It is true that during the mid-1990s efforts began to drive up the stock market valuation of major German companies by adopting a corporate policy centred specifically on a company's share price (shareholder value). More profitable companies that pay out a higher percentage of their net value-added to shareholders are valued more highly on the stock market. Thus German companies are slowly moving towards the Anglo-Saxon model of high profitability and high market value.

However, there is still a long way to go - and there is also a danger. What happens if foreign companies make hostile takeover bids for German conglomerates and then try to force the pace of the process of convergence? What if they start restructuring, merging parts of the business in order to concentrate on the company's core business and selling on other parts of the business without taking into account the interests of the employees, suppliers and customers in the affected regions? Such an approach may well yield short-term gains. However, the American experience suggests that shareholder gains from takeovers are often due not to greater efficiency but rather to a breach in the inherent contract between the company and customers and employees, and a redistribution of profits in favour of shareholders. Takeovers carried out with the sole intention of breaking up the target company threaten to destroy the deep-rooted German corporate culture based on the participation of all stakeholders. In the long term, this would have the effect of undermining one of the key pillars upon which Germany's economic success has been built.

The approval of a single liberal regulatory framework for takeovers for the whole of the EU carries clear dangers. From the German point of view, it would be no bad thing if the debate on the Takeovers Directive were extended further, leaving member states in the interim able to decide on their own regulatory systems (within the framework established by the European Court of Justice judgment). Europe is not yet ready for a single takeovers market. ■

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