

Toward a European Sale of Control Doctrine

From an American perspective, the most salient fact about European sale of control doctrine is that there is not much of it. Not much doctrine and, by comparison, not many sales of control either. What European rules there are that impinge on sales of control are either voluntary or quite recent, and in any event only an incidental byproduct of rules actually intended to regulate takeover bids.¹

In the United States, by contrast, an outpouring of legal cases and intense academic discussion about sale of control doctrine preceded the wave of hostile takeovers and their academic analysis. The 1950s and 1960s were inundated with cases and academic articles debating the existence and nature of the duty to share the sale of an existing block of controlling shares with the noncontrolling shareholders.² In contrast, the use of tender offers to create new control blocks, which made hostile takeovers possible by creating a mechanism to wrest control involuntarily from an existing control group, did not even begin until the 1960s. And it was not until the 1980s that these tender offers led to a torrent of caselaw and academic literature regarding hostile takeovers.³

It is hardly surprising that in Europe, as in the United States, voluntary sales of control have received far less media attention than hostile takeovers. Hostile takeovers not only offer more intrinsic drama, but unlike negotiated control sales they are played out in

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1. See Part I. All descriptions are of the state of the law at the time of the writing of this article in early 1993.

2. See, e.g., Jennings, "Trading in Corporate Control," 44 *Calif. L. Rev.* 1 (1956); Leech, "Transactions in Corporate Control," 104 *U. Pa. L. Rev.* 725 (1956); Hill, "The Sale of Controlling Shares," 70 *Harv. L. Rev.* 986 (1957); Berle, "'Control' in Corporate Law," 58 *Colum. L. Rev.* 1212 (1958); Berle, "The Price of Power: Sale of Corporate Control," 50 *Cornell L. Q.* 628 (1965); Brudney, "Fiduciary Ideology in Transactions Affecting Corporate Control," 65 *Mich. L. Rev.* 259 (1966).

3. See, e.g., Easterbrook & Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer," 94 *Harv. L. Rev.* 1161 (1981); Bebchuk, "The Case for Facilitating Competing Tender Offers," 95 *Harv. L. Rev.* 1028 (1982); Coffee, "Shareholders Versus Managers," 85 *Mich. L. Rev.* 1 (1986); Haddock, Macey & McChesney, "Property Rights in Assets and Resistance to Tender Offers," 73 *Va. L. Rev.* 701 (1987); Schwartz, "The Fairness of Tender Offer Prices in Utilitarian Theory," 17 *J. Leg. Stud.* 165 (1988).

public fora like the courts and legislatures. However, the resulting tendency to conflate private sales of control with hostile takeover bids is unfortunate. It obscures the important policy grounds for distinguishing between the two. These grounds, more obvious in America because of the historical sequence of its doctrinal development, have resulted in a U.S. corporate law that, unlike European law, treats private sales of control very differently from public tender offers.

Given my colleague Richard Buxbaum's recent paper admonishing that comparative law analysis must pay close attention to the country-specific structures that affect the desirability of given legal rules,⁴ it seems only appropriate to begin my inquiry with the question of what structural factors might explain the relative dearth of European sale of control doctrine. I address that question in Part I, concluding that in Europe capital market size and stockholding patterns historically made the problems raised by control sales more amenable to policing through informal or contractual means. This analysis suggests that, as the capital markets merge into a single European market, control sales are likely to become far more prevalent and problematic than they were previously. Indeed, because of the concentrated nature of current European stockholdings, the advent of the single market is likely to make sales of control even more important in Europe than they are in the United States. These same concentrated stockholdings also mean that European takeover bids are likely to prove far less frequent and practically significant than European sales of control.

I then move to the prescriptive. If a legal regime is going to regulate sales of control, how should it do so? I begin by spelling out in Part II the policy reasons for sharply distinguishing between sales of control and hostile takeover bids. I then outline in Part III the current state of legal policy debate about how best to regulate sales of control, explaining how the three leading approaches all represent alternative methods of trying to achieve an optimal tradeoff between the inevitable underdeterrence of harmful control transfers and overdeterrence of beneficial control transfers.

Finally, Part IV uses this developed legal policy analysis regarding corporate sale of control doctrine to assess a matter of great importance and topical interest: the advisability and meaning of the European Community's Proposed Thirteenth Directive on Takeovers. There are, I will show, plausible policy arguments for the proposed thirteenth directive as applied to takeover bids. But as applied to private sales of control, the effects of the proposed thirteenth directive would be perverse: raising obstacles to those control transfers least likely to be harmful. I then suggest means by which

4. See XIV *Journées Juridiques Jean Dabin* (Guy Horsmans forthcoming 1994).

these perverse, and unintended, effects on sales of control could be avoided through amendments or careful implementation and interpretation of the proposed thirteenth directive.

I. EXPLAINING THE DEARTH OF EUROPEAN SALE
OF CONTROL DOCTRINE

A. *The Current State of European Law*

In the American sense of the phrase, meaning a doctrine that in some circumstances makes it a violation of fiduciary duty for a controlling shareholder to sell a control block at a premium unavailable to the noncontrolling shareholders, there is no European sale of control doctrine. No country belonging to the European Community seems to ever impose liability on a controlling shareholder for the sale of his controlling block of stock.

What regulation there is in Europe instead takes the form of restrictions on the *buyer's* ability to buy the control block without also buying the remaining shares. But these restrictions are, in the European countries with the largest stock markets, manifested at most in *voluntary* codes of conduct.⁵ For example, in London, the largest stock exchange in Europe, the City Code on Take-Overs and Mergers provides that those who acquire more than 30% of a public corporation's stock must offer to purchase the remaining shares at the highest price they have paid in the last twelve months.⁶ But this City Code does not have the force of law. Rather, it is an ethical guideline promulgated by the nongovernmental Panel on Take-overs and Mergers. Nor are the means of its enforcement apparent. The most readily available enforcement mechanism, de-listing the corporation from the stock exchange, would harm a violating control buyer less than it would harm the supposedly victimized noncontrolling shareholders.

To be sure, special statutes or, more typically, corporate charters or shareholder agreements sometimes impose general restrictions on the transfer of certain corporations' shares in Germany, Italy, France, and the United Kingdom. But these provisions by and large do not distinguish the sale of a controlling block from the sale of any shares. And for those corporations that have no applicable general restriction on their share transfers, a control block can, in these countries, be sold at a premium unavailable to other shareholders.

5. 3 *Common Market Reporter* (Pending Legislation) ¶60,125, at p. 10,401 (CCH Int'l 1990) (noting that Germany, Italy, Netherlands, Ireland, and the United Kingdom have only voluntary codes of conduct). See also Heinz-Dieter Assmann, *Übernahmeangebots* 55 (1990) (stating that in Germany the buyer of a control block has no duty to make a public tender offer for the rest of the shares).

6. 2 *Doing Business in Europe*, ¶ 90-260, at p. 91,354 (CCH Int'l).

All this may be changing. The European Community's proposed Thirteenth Company Law Directive on Takeovers would require that those who acquire more than a specified threshold percentage of voting stock in a publicly traded corporation must make an equal bid for the remaining shares.⁷ The specific percentage of the threshold is to be set by each country, but cannot exceed 33%. At the time of this writing, this proposed directive had not yet been adopted. Nonetheless, some countries have apparently been inspired by the proposal (which was originally put forth in January 1989)⁸ to already adopt laws that would serve to implement it. In 1991, for example, Spain promulgated a royal decree requiring those who acquire more than 25% of a corporation's stock to make a tender offer at the same price for the remaining shares.⁹ In France, a 1989 regulation was promulgated requiring a person who obtained 33% of a corporation's stock to make a bid for at least two-thirds of the remaining shares.¹⁰ And I am told that Belgium has also recently passed a law requiring those who purchase a control block to make an offer for the remaining shares.

But these measures are quite new against a historical backdrop of near-total nonregulation of control sales. Moreover, even these measures do not really constitute a deliberate regulation of sales of control. Rather, as their very titles indicate, they are measures directed at public takeover bids that, largely by accident, happen to encompass private sales of control within their ambit.¹¹ No apparent attention was paid to negotiated nonpublic sales of an existing control block to a new owner, or whether they might differ in some relevant fashion from public takeover bids.

B. A Structural Explanation

What could possibly explain this dearth of sale of control doctrine in Europe, when there is such a wealth of caselaw on the topic

7. See Amended Commission Proposal for a Thirteenth Council Directive on Company Law concerning take-over and other general bids, 33 O.J. Eur. Comm. C240/7 (1990), reprinted in 3 *Common Market Reporter* (Pending Legislation) ¶60,200 (CCH Int'l). Article 1(2) of the proposed directive contemplates that in five years the rule may be extended to corporations whose stock is not publicly traded. See 33 O.J. Eur. Comm. at C240/11, 3 *Common Market Reporter* at p. 10,453.

8. See 32 O.J. Eur. Comm. C64/8 (1989).

9. See 2 *Doing Business In Europe* (New Developments) ¶120-899 (CCH Int'l).

10. See Law No. 89-531 of August 2, 1989, [1989] JO 4 Aout at 9822. See also Berger, "A Comparative Analysis of Takeover Regulation in the European Community," 55 *Law & Contemp. Probs.* at 62 n.38 & 66 (Autumn 1992) (collecting implementing regulations).

11. See also 3 *Common Market Reporter* (Pending Legislation) ¶60,200 (CCH Int'l) ("This proposal [for the thirteenth company law directive] is concerned principally with the way in which public take-over bids are conducted."); 2 *Doing Business In Europe* (New Developments) ¶120-899 (CCH Int'l) (Spanish regulation part of general regulation of tender offers).

in the United States? In both places, after all, sales of control raise a common problem: how to screen out control buyers who would abuse corporate control. The explanation, I think, lies in a different susceptibility to this problem. And that different susceptibility is linked to differences in the structure of the capital markets and corporate stockholdings.

In comparison to the United States, the capital markets of European countries are smaller and more intimate. The major players in the stock markets are relatively few and well-established. Buyers and sellers of large blocks of stock are thus more likely to know each other, and to be known by those able to finance their transactions. Moreover, a pattern of cross-holdings between corporations, and especially between corporations and their banks, means that in practice it will be difficult to transfer control without the approval of other major investors. And because concentrated ownership is in general more prevalent, large corporations in Europe are more likely to be closely held and governed by shareholder agreements restricting the resale of stock without the other shareholders' approval.

All this means that informal, social or contractual means of preventing the transfer of control to buyers who would harm the corporation is both more possible and more feasible. Reputational effects should also have greater effect because buyers and sellers of corporate control are repeat players who will lose future business from a bad reputation. And to the extent the community of buyers and sellers is small enough to have social meaning, nonfinancial incentives like the fear of social approbation will operate more powerfully.

The viability of informal, nonregulatory means of policing control sales in countries with intimate capital markets and concentrated cross-held stockholdings means that a legal doctrine to regulate sales of control has been relatively unnecessary in most European countries. Consistent with this explanation, it is Europe's largest, most anonymous market, the London Stock Exchange,¹² that was (with the City Code) the first to adopt some sort of regulation affecting sales of control, albeit one without legal force.

C. Implications for the Single Market

If this explanation is right, then sales of control are likely to become more problematic as Europe moves to a single capital market. Social or informal mechanisms of policing control transfers will be less effective because control buyers will be less well-known. In

12. The capitalization of the London Stock Market was, in 1988, greater than the capitalization of the stock markets in Germany, France, and Italy combined. See Coffee, "Liquidity Versus Control," 91 *Colum. L. Rev.* 1277, 1302-03 n.97 (1991).

part, of course, this is because control buyers will be more likely to come from foreign countries. But an additional factor is that, as capital markets become more free, it will become more feasible for less well-established persons or entities to raise the capital necessary to purchase large corporations. As the number of players increases, it will be less and less possible for informal or social means of control to function effectively. Eventually, the market may become as vast and anonymous as that in the United States. If so, it might become conceivable that in Europe, as happened in one famous U.S. case, a controlling shareholder could unknowingly sell to a buyer who had 38 prior unsatisfied judgments and 54 lawsuits pending against him.¹³

This is not at all to say that the move to a single capital market is ill-advised. Such markets allow greater accumulations of capital, higher economies of scale, more risk-diversification, and a better matching of investment needs to entrepreneurial skill. The extra societal wealth created by the resulting increase in productive and allocative efficiency is enormous. But, just as greater agency costs are an inevitable byproduct of publicly held corporations, so too less effective informal and social controls are an inevitable cost of moving to larger capital markets. It does no good to curse these adverse effects of larger capital markets as long as they are exceeded by the associated benefits.

The increase in adverse control transfers does, however, justify a re-examination of European legal policy toward sales of control. Indeed, despite the attention lavished on the regulation of takeover bids, the issue of sales of control is likely to prove far more significant in the years to come. Takeover bids are generally possible only if shareholdings are dispersed, so that a bidder can, by accumulating these shares, create a controlling block of stock to wrest power from the group, typically management, that currently exercises control. If a corporation already has a controlling shareholder, the chances of a takeover bid succeeding are exceedingly slim, indeed nil if that controlling shareholder has an outright majority.

In Europe, many large firms do not trade on the stock market at all, and of those firms that do trade, most already have controlling shareholders. In Germany, for example, only 402 corporations traded on the public stock market in 1988, and of those 402, fewer than 100 lacked a person or group that owned a controlling block of stock.¹⁴ The single capital market will create many profitable opportunities to sell or restructure corporate control. But given this stockholding structure, such opportunities are unlikely to be real-

13. See *DeBaun v. First Western Bank and Trust Co.*, 120 Cal. Rptr. 354, 357 (1975).

14. See *Coffee*, *supra* n.12, at 1302-03.

ized through takeover bids in the coming decades.¹⁵ Rather, they will be realized through negotiated transactions with the groups that currently own the controlling blocks of stock.

In the near future, then, sales of control will be more prevalent and pose more persistent problems in Europe than hostile takeovers. The issue of the proper legal regulation of control sales is thus one of great and independent importance. Indeed, the issue is likely to be far more important in Europe than in the United States because in the U.S., unlike Europe, most large corporations have no controlling shareholder.

Of course, once control blocks are sold and resold to buyers further removed from the corporate founders, it becomes more and more likely that the control blocks will be broken up to lower monitoring costs and increase risk diversification. And many control blocks will lose their relative clout as capital is pooled into ever larger businesses. It would thus not be surprising if in Europe, as in the United States, an initial wave of control sales was followed a few decades later by a wave of takeover bids. But for the foreseeable future it is likely to be sales of control that have more practical significance. The next few decades thus signal a time of great need, and opportunity, to fashion a European sale of control doctrine.

II. POLICY DISTINCTIONS BETWEEN SALES OF CONTROL AND TAKEOVERS

We must begin our analysis by clearly distinguishing corporate sales of control from corporate takeovers. Takeovers are transfers of control that are, from the standpoint of the group currently exercising corporate control, involuntary. That is why they are appropriately called *hostile* takeovers. Takeovers also involve the creation of a controlling block of stock through a transfer of shares from many unorganized individual shareholders to one buyer. Sales of control, in contrast, involve a transfer that is, from the perspective of the existing control group, voluntary. Moreover, the transaction does not involve the creation of a new control block assembled via a public tender offer to many shareholders but rather a negotiated sale of an existing control block by a person or coordinated group. These differences have policy significance for several reasons.

A. *Sharp Shifts in Corporate Policy*

Because hostile takeovers are involuntary and create new control blocks, they are more likely to cause sharp shifts in corporate

15. See Berger, *supra* n.10, at 70 ("one knowledgeable source estimates that there are only approximately thirty German companies that have a sufficiently dispersed shareholder base to allow a hostile bid to be successful.").

policy. A strong argument can be made that these shifts in corporate policy are desirable because they reflect the curbing of agency costs, namely management failures to operate corporations in ways that maximize corporate profits.¹⁶ But there is no doubt that the resulting corporate policy shifts often do harm identifiable persons. Operating the corporation more profitably may involve firing managers or laying off employees, ending customer or supplier relationships, increasing environmental harm or reducing charitable contributions, or taking on more debt or risk at the expense of corporate creditors or bondholders.¹⁷ Some would also argue that the prospect of takeovers makes managers excessively oriented to short term profits at the expense of long term investments in things like research and development.¹⁸

I do not here wish to take a stand on whether these objections to takeovers are persuasive,¹⁹ or whether (if persuasive) they would justify anything approaching the level of obstacles erected by current U.S. corporate law and widely advocated for European company law.²⁰ Rather, my point here is that whatever the persuasiveness of

16. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 171-75 (1991); Easterbrook & Fischel, *supra* n.3, at 1168-80.

17. See, e.g., Coffee, *supra* n.3.

18. See, e.g., Drucker, "Corporate Takeovers — What Is to Be Done?," 82 *The Public Interest* 3, 12 (1986); Lipton, "Takeover Bids in the Target's Boardroom," 35 *Business Lawyer* 101, 105 (1979).

19. Those interested in this issue should examine Easterbrook and Fischel's rebuttal of these objections. See Easterbrook & Fischel, *supra* n.16, at 175-205. Among the interesting pieces of empirical evidence they present are the following: (1) shareholders who sell to a takeover bidder receive on average a 50% premium; (2) shares left outstanding after a takeover increase by 30% in value; (3) corporate bonds and debentures do not on average decrease in value when takeover bids succeed; (4) firms acquired in takeover bids are no more likely to reduce wages or close plants than other firms; and (5) corporations that lower their investments in research and development increase, not decrease, the likelihood of takeover bids.

20. I would, however, point out that the political debate is often skewed against takeovers. This is because the losses from takeovers in jobs, sales, or loan defaults are easily traceable to those takeovers, and thus have great political saliency. The social gains from the greater corporate efficiency that results from takeovers are, comparatively, less traceable. Increased corporate efficiency should improve productivity and create new jobs, new sales, and better returns on investment. And if indeed overall efficiency is enhanced, these gains from takeovers should outweigh the losses. But those who gain from these positive developments are unlikely to attribute their good fortune to takeovers, whereas those who lose from takeovers are highly likely to affix the blame on those same takeovers. This, coupled with the human tendency to value the avoidance of a given loss more than the achievement of the same gain, see, e.g., Kahneman, "Experimental Tests of the Endowment Effect and the Coase Theorem," 98 *Journal of Political Economy* 1325 (1990), stacks the political debate against takeovers.

The political debate is even more skewed to the extent takeover barriers are erected by individual States belonging to a Federation. For such States can have incentives to impose inefficient barriers to takeovers in order to benefit local workers and businesses despite greater costs inflicted on shareholders, workers, and businesses located outside the State. See generally Romano, "The Political Economy of Takeover Statutes," 73 *Va. L. Rev.* 111, 138-41 (1983); Winter, "State Law, Shareholder

these objections, they have little or no bearing on sales of control. Because sales of control transfer an existing control block, they do not produce dramatic shifts in the incentives of the control group. The control buyer has the same incentives as the control seller to maximize corporate profits by terminating employment or business relations and by taking on debt or harming the environment. In takeovers, by contrast, the impetus for shifts in corporate policy comes from the fact that the new control group has greater incentives, because of its stockholdings, to maximize corporate profits than the old management control group did. Moreover, because a sale of control is voluntary, a controlling shareholder who wishes to sacrifice corporate profits to preserve current corporate policy can do so by refusing to sell to buyers who seem likely to change that policy.

B. Collective Action Problems

Because takeover bids involve the simultaneous solicitation of numerous dispersed shareholders, they pose potential problems of collective action.²¹ The most prominent problem is the possibility that individual shareholders might feel coerced to tender at a price lower than they value their shares.²² This coercion might exist if the tender offeror plans a two-tier transaction: first the tender offer then, after the takeover bid succeeds, a second tier transaction that merges or cashes out the remaining shareholders at less than the tender price. Alternatively, this coercion might exist even without a planned second-tier transaction if the tender price is higher than the value individual shareholders would place on their shares if the takeover succeeds and they are left stuck in a minority position.

This coercion reflects the exploitation of a collective action problem. If the shareholders were all acting together, they could refuse to accept a two-tier or partial offer that left them worse off than they were before. But because the shareholders tender individually, they have an incentive to tender even when they wish the tender offer would not succeed. This is because they each realize that their individual tender decision has little impact on the likelihood the tender offer will succeed and that, if the tender offer *does* succeed, they will be better off having tendered (because the tender price exceeds the second-tier price or the post-takeover value of their shares).

Concern about this coercion and collective action problem has

Protection, and the Theory of the Corporation," 6 *J. Legal Stud.* 251, 268, 287-89 (1977).

21. See generally Mancur Olsen, *The Logic of Collective Action* (2d ed. 1971); Russell Hardin, *Collective Action* (1982).

22. See generally Bebchuck, "Toward Undistorted Choice and Equal Treatment in Corporate Takeovers," 98 *Harv. L. Rev.* 1693, 1696, 1708-35 (1985).

inspired many U.S. state takeover regulations, including statutes that require a separate majority vote for a tender offer to succeed or that force the successful takeover bidder to offer nontendering shares the same price as the initial tender offer.²³ But again it is not my purpose here to enter into the debate about whether these coercion concerns justify such measures.²⁴ Rather, my point here is that these concerns are not at all present when the sale of an existing control block is at issue. For in such sale of control cases, the seller is a unitary decisionmaker acting for all his shares collectively who need not worry that if he rejects an offer the bid will go through anyway.

C. *Persuasiveness of Equality Norm*

An insistence that all shareholders receive an equal price makes more sense for takeovers than for sales of control. This is because in a takeover situation all the shareholders are in more or less the same situation: passive investors with dispersed holdings who individually lack the power or incentive to actively monitor the corporation. This being so, there seems little reason to think that some shareholders deserve a better price for their shares than others.

In a sale of control situation, by contrast, the controlling shareholders are in a very different position from the noncontrolling shareholders. The controlling shareholder must endure greater risk-bearing costs because his block of stock means that he cannot have a stock portfolio as fully diversified as noncontrolling shareholders. Further, the controlling shareholder has incurred the extra costs either of founding and building up the corporation (if he is the original controlling shareholder) or of assembling the control block,²⁵ and has ongoing responsibilities to oversee and monitor the corporation. These differences may justify a conclusion that the controlling shareholder does indeed deserve a premium on his shares, and that such a premium provides needed incentives to create and maintain a control block. Moreover, we must remember that the controlling shareholder is the investor who suffers the *least* from the agency costs that discount the value of corporate shares.²⁶

23. See Jesse H. Choper, John C. Coffee & C. Robert Morris, *Cases and Materials on Corporations* 1094-98 (3rd ed. 1989) (collecting statutes); Booth, "The Promise of State Takeover Statutes," 86 *Mich. L. Rev.* 1635 (1988).

24. For Easterbrook and Fischel's reasons to oppose efforts to redress this coercion, see Easterbrook & Fischel, *supra* n.16, at 179-81, which makes the following arguments: that two-tier offers themselves redress a different collective action problem that discourages takeover bids, that shareholders will benefit as long as the second tier price must be greater than the initial market price, and that competition between bidders will prevent coercive bids from succeeding.

25. See Elhauge, "The Triggering Function of Sale of Control Doctrine," 59 *U. Chi. L. Rev.* 1465, 1499 n.131 (1992).

26. *Id.* at 1487-88 & n.83.

The controlling shares thus have inherently more value, which makes it difficult to buy them without offering a premium unavailable to the noncontrolling shareholders.

D. Resulting Distinction in U.S. Law

In the United States, these policy grounds have led to the development of a sale of control doctrine that differs significantly from the law applicable to hostile takeovers. Under U.S. sale of control doctrine, a control block can be sold at a premium unavailable to other shareholders absent special circumstances.²⁷ If, in contrast, a bidder wishes to acquire a controlling block via a tender offer, then under Williams Act regulations the offer must be open to all shareholders, and all who tender are entitled to sell a pro rata share of their securities at the tender offer price.²⁸

More recent state takeover statutes may seem to undermine this distinction. They provide that the acquisition of certain percentages of stock, whether or not by tender offer, either requires approval by a majority of noncontrolling shareholders or entitles them to sell their shares to the acquirer at a "fair price" usually equivalent to the premium price paid for the control block.²⁹ On the surface, these statutes may seem to resemble the sort of regulation present in the City Code or the Proposed Thirteenth Directive. But there is a fundamental difference. Namely, the U.S. state statutes generally allow the corporation to opt out of the regulation by amending the corporate charter or bylaws.³⁰ This means that the practical effect of these state takeover statutes is limited to situations where the existing control group is hostile to the purchase offer. In voluntary sale of control cases, the existing owner of a control block will ordinarily have little trouble opting out of the restriction.

Whether or not the actual distinction drawn in U.S. law is justified remains debatable. One can make strong arguments that, like sales of control, takeover bids should largely be deregulated.³¹ And one can make a strong argument that norms of equal treatment of shareholders should be extended from tender offers to sales of control.³² (I will, however, argue in Part IV that these norms do not justify the form of equal treatment required under the Proposed Thirteenth Directive.) But I hope I have shown enough to convince the reader that sales of control and takeover bids present distinct policy issues. While ultimately one might reach similar conclusions

27. *Id.* at 1467-81. I describe these special circumstances briefly at the text accompanying n.48.

28. See SEC Rule 14d-8, 14d-10.

29. See Choper, Coffee & Morris, *supra* n.23, at 1094-98.

30. See Elhauge, *supra* n.25, at 1480 n.58 (collecting and analyzing statutes).

31. See, e.g., Easterbrook & Fischel, *supra* n.16, at 162-211.

32. See, e.g., Robert Clark, *Corporate Law* 494-98 (1986).

about both of them, the steps of the analysis and the empirical questions differ. At a minimum, then, the European Commission and other European lawmakers should clearly separate out the issues raised by sales of control from those raised by mergers and hostile takeovers.

Having separated out the issue, we are still left with the question of what policy considerations should guide us in determining how to regulate sales of control. It is to that issue that I turn next.

III. THREE ANALYSES OF SALE OF CONTROL DOCTRINE

The concern raised by sales of control is straightforward: that the buyer of control will abuse that control to loot, self-deal, take corporate opportunities or otherwise harm the corporation. On the other hand, sales of control are often value-enhancing. They may transfer control to someone who has plans to operate the corporation more profitably, or to someone who places greater value on the control block because it better fits his investment portfolio or because he has more time and energy for management or supervision than the control seller.

The trick here, as elsewhere in law, is to deter the undesirable conduct (harmful control transfers) without unduly deterring the desirable conduct (beneficial control transfers).³³ Doing this directly, by having judges or other government officials decide case-by-case which control transfers are beneficial, is not advisable. The difficulty of projecting the expected value of control transfers, the likelihood that adjudicators of this would err, and the costs, uncertainties, and delays of relying on the litigation process all combine to render a case-by-case process of adjudicating control transfers unworkable and undesirable.³⁴ Instead, the three leading approaches propose rules designed to create incentive structures that guide private actors in ways that aim to produce an optimal tradeoff between the underdeterrence of harmful control transfers and the overdeterrence of beneficial control transfers. These include the equal sharing approach, the deregulatory approach, and the triggering approach, the last of which represents the approach currently taken by U.S. law.

A. *The Equal Sharing Approach.*

As proposed by William Andrews, the equal sharing approach seeks to selectively screen out harmful control transfers by giving all shareholders the right to participate, in proportion to their stock-

33. See generally Elhauge, *supra* n.25, at 1494-97 (describing the inevitable legal tradeoff between overdetering desirable conduct and underdetering undesirable conduct).

34. See *id.* at 1494, 1498.

holdings, in any sale of control.³⁵ To illustrate, if a purchaser were interested in purchasing a 30% control block, the owner of that 30% block could not simply sell his own shares. Instead, all shareholders would be entitled to sell 30% of their shareholdings. If all exercised this right, the original controlling shareholder would be left with a 21% stake.

Andrews observed that this equal sharing rule would not block a sale of control unless three things happened all in the same case. (1) The original controlling shareholder refused to sell less than his entire control block. (2) The control buyer would not or could not purchase 100% of the corporate stock. *And* (3) the noncontrolling shareholders withheld consent from an unshared control sale.

This confluence of factors, Andrews reasoned, was unlikely to happen if the control transfer was beneficial. The original controlling shareholder should be happy to sell only a pro rata share of his securities if he felt the control transfer would be beneficial, for any shares he kept would increase in value. If the original controlling shareholder was unwilling to remain a proportional shareholder, a value-enhancing control buyer should be willing to buy 100% of the corporate stock to conclude the sale because the more shares he owns the more he profits when corporate value increases. If the control buyer lacks the funds to buy 100% of the corporate stock, he still ought to be able to raise the financing by persuading the capital markets that the control transfer will increase corporate value. And if none of this works, he ought to be able to convince the noncontrolling shareholders to consent to an unshared control transfer because their unsold shares will increase in value if the transfer is going to increase corporate worth.

In other words, the equal sharing rule would deter a control sale only if the buyer convinced neither the original controlling shareholder, nor the capital markets, nor the noncontrolling shareholder that the control transfer would increase corporate value, and the buyer was not sufficiently convinced himself to purchase 100% of the corporation. This would be unlikely to true, Andrews concluded, unless the control transfer was in fact harmful to the corporation.

B. The Deregulatory Approach

The deregulatory approach challenged the analysis of the equal sharing approach. Its basic premise, as articulated by Easterbrook and Fischel, is that "[a]ny attempt to require sharing simply reduces

35. See Andrews, "The Stockholder's Right to Equal Opportunity in the Sale of Shares," 78 *Harv. L. Rev.* 505 (1965). For a more detailed explanation of the equal sharing approach, see Elhauge, *supra* n.25, at 1483-86.

the likelihood that there will be gains to share."³⁶ Various reasons can be adduced for this conclusion.

First, even if a control transfer seems likely to enhance corporate value, a control seller and buyer might legitimately object to a proportional sale because, standing alone, such sales decrease the per share value of the controlling and remainder block of stock.³⁷ Consider, for example, the illustration above, where the proportional sale leaves a 30% control buyer with a 21% contending block. This divided control will inevitably produce conflict over corporate policy, which imposes costs in effort, delay, and missed business opportunities. More important, a significant part of the value of a control block is that it suffers a lower agency cost discount than the other shares.³⁸ Accordingly, the incomplete control that exists in a 30%/21% situation means that the 30% control block will have less value than if it were the only large block of stock. Further, for any given level of corporation profits, the 21% remainder block will have far less per share value than a sole 30% block would. A proportional sale requirement will thus deter value-enhancing control transfers unless the per share gain from the transfer's beneficial impact on corporate profits is large enough to exceed the increased agency cost discount inflicted by the proportional sale on the per share value of both the 30% block and the original controlling shareholder's 21% remainder block.

Second, control buyers have legitimate reasons to be reluctant to purchase 100% of a corporation even if they will enhance corporate value.³⁹ The main reason is that increasing their financial stake in a single corporation means that their investment risks are less diversified. (They could, of course, seek co-investors, but that poses the same problems of conflict and incomplete control outlined in the last paragraph). This is unfortunate because controlling shareholders must already incur substantial risk-bearing costs to invest in a controlling block of stock. Where the additional increase in risk-bearing costs imposed by a 100% purchase requirement exceeds the gain in corporate value, such a requirement will deter desirable control transfers.

Third, even if control buyers do have plans to increase corporate value and are willing to purchase 100% of a corporation, they may not be able to finance the purchase.⁴⁰ The plans may be secret or hard to communicate to lenders. Or, because debt has its own agency costs that exceed those suffered by the controlling share-

36. Easterbrook & Fischel, "Corporate Control Transactions," 91 *Yale L.J.* 698, 698 (1982). For a full explication, see Elhauge, *supra* n.25, at 1486-93.

37. See Elhauge, *supra* n.25, at 1486-88.

38. *Id.* at 1487-88 & n.83.

39. *Id.* at 1489.

40. *Id.* at 1488-89.

holder, lenders may demand risk-adjusted rates of return greater than those the control buyer gets or can pay. More generally, because debt/equity ratios reflect a tradeoff between the agency costs of debt and equity,⁴¹ a requirement that control buyers finance the purchase of 100% of the stock requires a deviation from the ratio that minimizes total agency costs. When the extra agency costs of increasing debt exceed the gain in corporate value from the transfer, a desirable control transfer will be deterred.

Fourth, because controlling shareholders often profit from non-shareholder relations with the corporation, they may demand a per share price for controlling shares that exceeds the average value corporate shares would have after a value-increasing control transfer.⁴² In such situations, productive control transfers will be deterred unless the control seller receives a premium price unavailable to the other shareholders.

Finally, even when a control transfer creates corporate gains, noncontrolling shareholders have incentives to withhold consent to get a greater portion of those gains. Bargaining over the distribution of gains may break down because of strategic behavior or the transaction costs of getting consent from all the shareholders.⁴³ Or collective action problems may block consent because the noncontrolling shareholders know that their individual refusal to consent has little impact on whether the control sale succeeds but that they will get a better price if the control sale does succeed and they have withheld consent, because they will then get the same premium price received by the controlling shareholder.

C. *The Triggering Approach*

The above analysis establishes that the equal sharing approach does, indeed, significantly overdeter value-increasing control transfers. But it does not establish that this overdeterrence of desirable control transfers is not outweighed by the greater deterrence of undesirable control transfers offered by the equal sharing approach. For that conclusion, the deregulatory approach relies on empirical evidence suggesting that the stock market price of noncontrolling shares tends to increase after a sale of the controlling block of stock.⁴⁴ The apparent conclusion drawn is that overdeterrence is a

41. See Jensen & Meckling, "Theory of the Firm: Management Behavior, Agency Costs and Ownership Structure," 3 *Journal of Finance Economics* 305, 342-51, 355-56 (1976).

42. See Easterbrook & Fischel, *supra* n.36, at 708-11, 716.

43. See Elhauge, "Does Interest Group Theory Justify More Intrusive Judicial Review?," 101 *Yale L. J.* 31, 95-96 & nn.246-47 (1991) (describing obstacles to value-increasing, or Coasian, bargaining).

44. See Easterbrook & Fischel, *supra* n.36, at 717-18; Holderness & Sheehan, "The Role of Majority Shareholders in Publicly Held Corporations," 20 *Journal of Finance Economics* 317 (1988). Holderness and Sheehan's influential study is relied

bigger problem than underdeterrence.

Whether the empirical evidence justifies the conclusion that control transfers generally enhance corporate value is a matter I will not dwell on here.⁴⁵ The more important points are the following. One, because current U.S. law already sometimes imposes the equal sharing rule, the present desirability of most control transfers may simply indicate that current doctrine does a good job of screening out undesirable control transfers by selectively triggering the equal sharing approach.⁴⁶ Two, even if, over all cases, the mix of over- and underdeterrence of the deregulatory rule is better than that of the equal sharing rule, we need not settle for a single rule. Instead we can selectively use two rules, triggering each rule in the circumstances where its over- and underdeterrence seems less problematic than that of the other rule.

This third approach to sales of control is the one that, in prior writing, I have advocated and argued actually underlies the U.S. caselaw.⁴⁷ This approach recognizes the strengths and weaknesses of the equal sharing and deregulatory rules and uses a meta-doctrine to trigger the rule that is most appropriate to the circumstances. Because the equal sharing rule reduces underdeterrence of unproductive transfers at the expense of increasing overdeterrence of productive transfers, it is best suited for a mix of cases that mainly includes unproductive transfers. Because the deregulatory rule has the opposite effects, it is best suited for a mix of cases that mainly includes productive transfers. A triggering doctrine roughly segregates cases into two classes — a class of cases that contains mainly productive transfers, and another class that contains mainly unproductive transfers — and then triggers the rule best suited for the situation. This optimizes over- and underdeterrence better than using either rule across the board could.

I shall have to refer those interested in a complete explanation

upon in ALI, *Principles of Corporate Governance* § 5.16 comment c & reporter's note 1 (Proposed Final Draft 1992); Ronald J. Gilson & Bernard Black, *The Law and Finance of Corporate Acquisitions* 137-39 (Supp. 1991); and Larry Ribstein, *Business Associations* 1004 (1990).

45. One can raise questions about the empirical evidence. The information presented in Easterbrook & Fischel's piece, for example, established that stock market prices rose in the famous case of *Perlman v. Feldmann*. But that rise may have simply reflected the expectation that the shareholders would get part of the control premium in litigation. Holderness & Sheehan's study shows that the market price increases when a majority control block is sold. But this does not mean that sales of control blocks smaller than 50% increase the value of the noncontrolling shares. For other problems with relying on stock market prices, see Elhauge, *supra* n.25, at 1492.

46. *Id.* at 1500. Indeed, in the Holderness & Sheehan study itself, 10 of the 31 control sales complied with some equal showing norm, suggesting the triggering threat has real bite.

47. Elhauge, "The Triggering Function of Sale of Control Doctrine," 59 *U. Chi. L. Rev.* 1465 (1992).

of how current U.S. law accomplishes this triggering function to my prior work on the subject.⁴⁸ But the outlines of the explanation can be summarized here. In essence, U.S. law triggers the equal sharing rule whenever the circumstances suggest the control transfer seems likely to significantly increase the risk of control abuse. The circumstances fall into three exceptions to the general rule permitting unshared control sales. First, when the facts raise a reasonable suspicion that the control buyer will loot, the sale to looters exception applies. Second, when the stock transferred is too low a percentage to constitute "working control" but the agreement calls for a transfer of corporate offices, the sale of office exception applies. Third, when there are other, more subtle, structural reasons to believe that control abuses will be more likely or harder to police, the exceptions for diverting "corporate" or "collective" opportunities are deemed to apply.

IV. A CRITICAL ANALYSIS OF THE PROPOSED THIRTEENTH DIRECTIVE

Given my prior work, I am ultimately drawn to the normative conclusion that European sales of control should be governed by the two-rule triggering approach outlined above. But one need not go this far to agree with me that, as applied to sales of control, the European Community's proposed Thirteenth Company Law Directive is ill-advised and indeed perverse in its effects.

The preamble to the proposed Thirteenth Directive cites two grounds for the proposal: (1) to provide shareholders with equal treatment, and (2) to protect minority shareholders from partial bids.⁴⁹ Beginning with the first justification, I have already set forth my reasons (in Section II.C) to believe that equal treatment norms have far less force for sales of control than for takeover bids. It is, moreover, not at all obvious why the law should insist on equal treatment if, for the reasons outlined in Section III.B, such equal treatment will deter productive control transfers and thus result in a net *decrease* in the value of noncontrolling shares. Pareto's principle, that we should allow uneven gains as long as they make some persons better off and none worse off, seems to me to carry greater moral weight.

But there is a more telling reason to reject the equal treatment explanation here, namely that the proposed directive does not really fit the equal treatment rationale. A control buyer cannot satisfy the proposed thirteenth directive by, say, buying a 35% control block through pro rata purchases from each shareholder at the same price

48. See *id.* at 1503-23.

49. 33 O.J. Eur. Comm. at C240/7 to C240/10, reprinted in 3 *Common Market Reporter* at p. 10,451.

even though such a pro rata purchase would treat all shareholders equally. Nor does the directive provide any equal treatment to shareholders when the purchaser buys a control block smaller than the threshold set by the individual Member States.

The second justification is that the directive protects minority shareholders by avoiding partial bids. The Commission does not explain what it is about partial bids that it thinks poses such a threat to minority shareholders, but one might surmise it is concerned about the collective action problems described in Section II.B. These collective action problems, we saw there, can make dispersed small shareholders feel coerced into accepting a tender offer because they fear it will succeed and that the post-takeover value of their shares will be lower than the tender price. A rule requiring takeover bidders to follow up an initial tender offer that succeeds in creating a control block with another one at the same price open to all shareholders would eliminate this coercion. With such a rule, the initial tender offer would not succeed unless the tendering shareholders felt the tender price exceeded the pre-takeover value of their shares.

But these collective action problems have no application to the sale of an existing control block. The requirement that the buyer of a control block offer to purchase all the remaining shares at the same price thus does not serve the Commission's articulated goal. Furthermore, requiring control buyers to purchase 100% of a corporation's stock would, as explained in Section III.B, deter many value-enhancing sales of control. The increased risk-bearing costs of forcing 100% investments (and the increased agency costs from disturbing optimal debt/equity ratios) will deter many desirable control transfers. Desirable control transfers will also be deterred whenever their execution requires an unequal division of the premium because of the extra value the original controlling shareholder derives from nonshareholder relations with the corporation.

This overdeterrence goes well beyond that of the equal sharing approach, for that approach would allow the sale of just a control block as long as it was open pro rata to all the shareholders. Such pro rata sales provide more than adequate incentives for the original owner of the control block to screen out undesirable control transfers because a pro rata sale exposes the original controlling shareholder to the same benefits and risks from the transaction as those experienced by the noncontrolling shareholders. The controlling shareholder is thus just as likely to make a wise business decision in making a pro rata control sale as when he selects a manager or approves the investment of corporate funds. But such pro rata sales would not be permitted under the proposed Thirteenth Directive.⁵⁰ Nor would the directive apparently allow an exception where the

50. Again, this makes good sense as to takeover bids, because the equal sharing

noncontrolling shareholders consented to an unshared or partial sale of control.

Worse, the proposed Thirteenth Directive would increase overdeterrence for precisely those control transfers that are *least* likely to increase the risk of control abuse: namely those where the control block is large. The larger the control block, the less attractive it will be for any controlling shareholder to harm the corporation. A shareholder with a 20% controlling block of stock can make \$8 for every \$10 dollars of corporate funds he steals or diverts through self-dealing or other control abuses. A shareholder with an 80% control block gets only \$2 out of every \$10 taken from the corporation. Any given regime of legal penalties will thus be more likely to deter control abuses by the 80% shareholder than the 20% shareholder.

In short, in setting a threshold of up to 33% *above* which special rules apply, the proposed directive is nothing less than perverse. Transfers of control blocks *below* 33% (or whatever threshold a country sets) are far *more* worrisome than transfers of control blocks above that percentage. Yet the former receive no regulation at all, whereas the latter are burdened with regulation in all disproportion to the concerns they raise.

The proposed Thirteenth Directive has been amended once before, and one way to avoid this perverse effect would be to amend it once again. Such an amendment could simply provide that the directive applies only to acquisitions of a control block by tender offer. More ambitiously, an amendment could make the equal sharing approach applicable for all sales of an existing control block. Pro rata offers, rather than 100% offers, would then be required, and the rule would apply to any block of stock (above or below 33%) that sufficed to give the shareholder effective control over elections to the board of directors. Or, in my preferred approach, private sales of control could be governed by a triggering doctrine, which would make the equal sharing rule applicable only when the sale of control significantly increased the risk of control abuse. The precise circumstances indicating such an increased risk is, to my mind, a matter best left to each Member State, but a useful start might be the American law on the topic.⁵¹

Even if the proposed Thirteenth Directive is in fact adopted, there are plenty of ways to avoid its unintended effect on control sales by careful implementation or interpretation. One way is for the supervisory body of an individual country to exercise its power

approach does nothing to stop the coercion arguably implicit in such bids. But it makes little sense as applied to sales of control.

51. See Elhauge, *supra* n.25, at 1467-81, 1503-23 (describing and analyzing the U.S. law in detail).

under Article 4(3) of the directive to grant an exemption from the duty to bid for all a corporation's securities.⁵² The only limitation on this power is that the supervisory body must provide "reasons" for any exemption it provides. The policy grounds articulated above would seem to provide more than reason enough. And to these grounds could be added the fact that the Preamble and legislative history clearly indicates the Thirteenth Directive was intended to regulate takeover bids, not sales of control.⁵³ Citing these reasons, supervising bodies should, in implementing the Thirteenth Directive, create an exemption for the negotiated sale of an existing control block. They could also go further and apply, to those sales of control exempted from the Thirteenth Directive, the equal sharing or triggering approaches as outlined above.

Finally, one could interpret the Thirteenth Directive in a manner designed to render it inapplicable to private sales of control. Such an interpretation would focus on Article 1 of the Directive, which provides that it applies to "take-over and other general bids" for corporate securities.⁵⁴ The Directive defines a "general bid" simply as "an offer made to the holders of the securities of a company to acquire all or part of these securities."⁵⁵ However, in light of the clear focus of the Preamble and legislative history on hostile takeovers, the use of the word "general" to modify "bid," and the suggestion the offer must be made to multiple "holders" of securities, one could interpret the Directive's language to mean the same thing as a "tender offer" means under U.S. law.⁵⁶ Such an interpretation would effectively exclude private sales of control from the scope of the Directive.

V. CONCLUSION

While European company law has traditionally had no sale of control doctrine, those days may be ending. The proposed Thirteenth Directive may impose a sale of control doctrine of sorts. And even if it does not, the merging of European capital markets is likely to make sales of control far more frequent and problematic, thus ul-

52. See 33 O.J. Eur. Comm. at C240/15, reprinted in 3 *Common Market Reporter* ¶60,200, at p. 10,471. See also 3 *Common Market Reporter* ¶60,130, at p. 10,403.

53. The Preamble focuses on takeover bids and does not mention the sale of an existing control block. See 33 O.J. Eur. Comm. at C240/7 to C240/10. The legislative history demonstrates the same focus. See 32 O.J. Eur. Comm. C64/8 (1989) (setting forth the original proposal) 32 O.J. Eur. Comm. C298/56 (1989) (Report on the Proposal by the Economic and Social Committee)

54. 33 O.J. Eur. Comm. at C240/11, 3 *Common Market Reporter* at p. 10,453.

55. See Article 2, 33 O.J. Eur. Comm. at C240/12, 3 *Common Market Reporter* at p. 10,453.

56. For cases defining a "tender offer," see, e.g., *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979); *Brascan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773 (S.D.N.Y. 1979).

timately provoking the creation of a doctrine explicitly directed at control sales.

In the meantime, it will be important to keep three things in mind. First, a crucial distinction exists between takeover bids and sales of control. Legal policy analysis of corporate control shifts cannot hope to be coherent unless these two different forms of control shifts are carefully distinguished and separately analyzed. Second, any rule regulating sales of control will inevitably require tradeoffs between overdetering desirable control transfers and underdetering undesirable control transfers. But legal regimes can, by employing a triggering doctrine, restrict particular rules to those classes of cases where their over- and underdeterrence is least problematic. Finally, in adopting, amending, implementing, or interpreting the proposed Thirteenth Company Law Directive, legal decisionmakers can and should avoid the perverse unintended effects the directive could have on sales of control.

