CONTROLLING COMPANY TAKEOVERS

By Regulation or By Contract?

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Controlling Company Takeovers: By Regulation or By Contract?

The market is from both a practical and theoretical point of view central to an understanding of the topic of corporate, or as is said in New Zealand, company control. The history of the field has witnessed many twists and turns. The subject of company control first came to prominence in the United States in the early 1930s with the early studies by Adolph Berle and Gardner Means who identified the major conflicts of interest that arose from the separation of ownership and control in the modern corporation. It then fell 30 years later to Henry Manne to identify the market for corporate control as a means whereby disorganised shareholders could exert their influence over a company by selling shares to an outsider raider who could then obtain a control block of shares within the corporation. These raids were in fact organised on a large scale during the 1980s, and they in turn provoked a variety of defensive responses that depended on a combination of legislative anti-takeover statutes and contractual devices. The rate of corporate takeovers has continued apace in the 1990s, where the trend has been more toward friendly agreements than hostile takeovers. But the sweep of recent history invites, and perhaps requires, a reexamination of the subject as a matter of first principle.

In approaching this topic I must at the outset make two caveats. Although I have followed the takeover movement and company law literature with some interest, I have never taught company and securities law. In one sense this lack of detailed knowledge counts as something of a blessing because it allows me to look at these areas of law as the confluence of other subjects, most notably contract law on the one hand and some of the elements of planning, such as real estate development or estate planning, on the other. Thus instead of focusing on the relevant statutes as company lawyers do, I prefer a strategy of remorseless disaggregation of transactions into their constituent parts. Instead of trying to figure out how a complex transaction works, taken in one bite, my approach is to see how it is built up out of a variety of simple building blocks and to explore any tensions that arise when one discrete transaction rubs up against another.

The second caveat I want to make has to do with the position of being 'a stranger in a strange land'. I do claim more knowledge of New Zealand than a random foreign academic, as this is my third visit and in the interim I have kept up to date with some of the local debates. But that knowledge still comes from a distance, so when one lacks specific knowledge, one appeals to universal principles. Hence while I will make a few remarks about the current New Zealand scene, I want to deal with the takeover issue generally, from the point of view of somebody who is a contracts and common law lawyer first and a companies and statutory lawyer only second.

Are share dealings different from other contracts?

The first principle that is relevant in this context is freedom of contract with respect to commercial transactions. I do not want to defend it, at least for the moment, as an ultimate philosophical principle but I do want to defend it as a way of understanding how the law of companies develops out of the law of contract.

Freedom of contract normally makes parties masters of their own offers. You are not bound to accept any transaction against your will. Nor, of course, is anyone else. In consequence, you phrase offers in terms that you think will be congenial to the other party, lest you expend wasted effort in an offer that is not accepted. That party is in turn free to reject or accept the offer, or to counteroffer, until both sides reach some kind of harmony. The mere fact that each side is free to walk away until the deal is struck provides a powerful disciplinary element on the content of the offers and counteroffers. The net gain to the parties is always net of transaction and negotiation costs; making offers that meet the needs of the other side is one effective way to reduce these deadweight losses.

How does this contracting process apply to a shareholder? The simplest kind of offer that a person can make is an offer to buy one share from another individual. Any claim that is associated with the property rights in the shares gets transferred from A to B in exchange for monetary consideration which goes in the opposite direction.

It is important to recognise what is at stake in this transaction. While a share can easily be conceptualised as a piece of property, it is radically different from other things that we call property, for example a sack of potatoes. That is, when a sack of potatoes is transferred from seller A to buyer B, ownership passes from A to B but the position of all other individuals who by definition are strangers to the transaction is not altered in any material way by that transfer of rights. Shares are different from potatoes or bushels of wheat in that they are claims by an individual over a set of assets held in a corporate structure which has multiple owners. A simple assignment of a single share not only changes the ownership of a financial claim but also the political organisation that collectively governs the company. It is therefore not possible to think of a share transaction as merely a voluntary exchange between two individuals standing apart from the rest of the world. One has to take into account the possibility of external effects, positive and negative, on the interests of other individuals who have stakes in the company enterprise.

Companies divide themselves in this respect into two classes: private or closely held companies and public or open companies. In a private company, any change in share ownership effects a change in a small community. A shareholder might conclude "I don't like my brothers so I am going to substitute somebody in my place". This behaviour is generally not welcome. It creates disruption, and the identity of other shareholders may have been a consideration in the original investors' minds that contributed to their participation. So with shares in private companies it is common to see powerful restraints on alienation for the protection of others with retained interests in the firm.

Thus, a prospective buyer may make an offer, but the offeree may not be free to accept that offer because of their previous acceptance of some restraint on alienation that came with the initial acquisition of the shares in question. The judgment is quite simple: the contractual arrangements established when the firm was set up envisaged that the external effects on the current shareholders of the private company might best preclude free alienation of shares. This possibility is not unique to company law. The substitution of one of a number of owners of a collective asset changes the nature of its corporate governance, whether it be a closely held company, a cooperative, a condominium, a real estate subdivision or a similar collective entity. In all, the restraint on alienation to protect retained proprietary interests is a common theme.

Now how does one extend this logic to a public company? If we consider a sale of one share from one individual to another, the gains or losses associated with the voluntary transaction between the two parties are fairly evident and the external effects are generally negligible. A single share is a small fraction of the whole, and the other shareholders for the most part acquiesce in, or even are quite comfortable with, the separation of ownership and control.

Indeed, one thing that we learn from a simple share transaction is that the separation of ownership from control, which in the legacy of Berle and Means is often put down as a negative feature of the modern company, has powerful positive features as well. As a shareholder, I may not have any control over the operation of the company, which may be a minus from my point of view, but the fact that none of the other shareholders in the company has any control over its operation either is an enormous offsetting plus. This is one of the explanations for having limited partnerships and anonymous shareholdings. There is a relatively small group of individuals, the directors, whose conduct you have to monitor in order to make estimations about share value. The fact that other shareholders are also passive actually induces you to invest in such a company.

Since we have this principle of implicit passivity associated with an individual share, we would expect free alienation of single shares to be the norm; the way to induce people to invest in companies is to assure them that their investment is relatively liquid. In private companies where there is not free alienation of shares, there has to be complicated buyout arrangements in the event of death, disability or retirement of a shareholder, who is frequently an officer of the firm. In a public company none of this is required; a small number of shares can be sold freely on a voluntary exchange market. Thus, the sale of the individual share will have exactly the same legal treatment as the sale of a bushel of wheat, the externalities on other shareholders will be ignored, and the gains from trade between the private parties will be regarded as the dominant factor.

Now, what happens when we engage in aggregation and start having larger offers? When you go from one bushel of wheat to two bushels of wheat, there are still no externalities involved. It is only when the aggregation of bushels of wheat becomes large that people think that you have a corner on the market and start worrying about a monopoly position. I think that for the most part market-cornering efforts in extensive commodity markets are self-defeating strategies that are better ignored rather than worried about. For example, the effort of the Hunts in the United States to corner the market in silver in the late 1970s failed because people melted down their silverware when the price of silver got too high and put it on the market. But shares are unlike wheat: you cannot grow more of them. Bidders determined to take over a company can extend an offer either in series to multiple individuals or in one action to everybody, and acquire all the shares. Now the public company starts to look rather more like the private company that we considered earlier. Even with a bid for 20 to 30 percent of the shares of a company, the external effects are going to be large because the change in share ownership may result in a change of effective control.

If an individual share is freely alienable, individual shareholders can sell any number of shares and any number of individuals can sell to a single bidder, if that is what they want to do. There is no clear point at which you change from the regime of free alienation where externalities do not matter to a regime of non-free alienation because the externalities do matter. So the default rule in contract construction would be that you leave it up to the company and its shareholders to decide in advance whether or not they want to impose any restrictions on dispositions by their shareholder members.

Are restrictions against takeovers justified?

An important asymmetry in dealing with takeovers and tender offers is that we do not have to worry about any of the internal politics of the acquiring company. We treat its shareholders as a coherent team. The question is what the target company is to do in the event of a takeover bid or tender offer and whether takeover rules of any kind need to take into account the fact that the sale of shares is rather different from a sale of wheat, bearing in mind these external effects.

There are two separate stories that typically can be told about target companies, and these have radically different implications for the response we might allow them to make. One story is that management is derelict, incompetent, slow of speed and dim of mind, and the other is that management is nimble and shrewd in all things to do with the business of the company and the welfare of the shareholders. There is nothing to indicate *a priori* which of these types the target company is going to be. And, in fact, the type of company that generally will be a target is not at all clear: a bidder may go after incompetent managers to replace them with a better team or after a well-managed firm in the hope of obtaining merger synergies. We have to devise a set of rules that does not depend upon distinguishing between these categories at the time the initial tender offer is made. This is the problem, of course, that a body like the New Zealand Stock Exchange faces when trying to draw up sound exchange rules.

The first scenario was discussed at great length by Frank Easterbrook and Daniel Fischel in their work which culminated in *The Economic Structure of Corporate Law* (1991). They discussed the case of a target company with lazy, shiftless management which would be galvanised into action by the dangers that a takeover posed to their control. The nature of the transaction is one in which previously dispersed shareholders come together in the hands of a single entity with enough votes to control the board of directors. The newly empanelled board of directors has a rather different vision for the company, which involves ejecting the current management and replacing it with the board's own choices. This we would translate as being a social good, because it means getting rid of the old incompetents and substituting more vigorous and capable people.

Now what could the incumbents do to sabotage the transaction? One thing a target company can do is make its assets worthless to any purchaser, so that the existing managers can hold on to their salaries and perquisites. So the incumbents sell off assets at below-market prices, take on large amounts of debt which is difficult to service, and systematically disturb the balance of corporate assets in a way that will make the company less valuable for takeover. This is self-consciously to exploit the conflict of interest which agency theory tells us exists between the management team on the one hand and the shareholder group on the other.

This would be a bad situation. Easterbrook and Fischel's response was clear. If existing management might take a perfectly good set of working assets under bad control and turn them into a bad set of assets under bad control, then it is important to make sure that the tender offer succeeds if the shareholders want it to succeed.

This conclusion has two implications. The first is that we require utter passivity by management in the face of the takeover bid. Whereas they may normally have had power to undertake major corporate transactions, once a tender offer or takeover bid is made management should neither lobby shareholders nor misrepresent or undermine the value of the company's underlying assets. In a takeover situation we regard the externalities on other shareholders as presumptively positive. The transfer of a control block of shares means that everybody is likely to be made better off by the substitution of good management for bad.

The second implication is that we should not allow defences under corporate law against the takeover bid. The key issue is not whether the raider will offer the highest price in the short run but whether it is in a position to consummate the transaction to effect the desired shift in control from poor to better management. Contrary to this view, however, some of those involved with US securities markets decided that there was an undesirable aspect to American corporate law that they wished to excise. The response was to introduce a new set of rules regulating tender offers under the Williams Act passed by the US Congress in 1968. The Williams Act 1968 amends the Securities Exchange Act 1934 so that an acquiring company that makes open market purchases in order to get a toehold in another company has to stop buying once it has acquired 5 percent of the shares. The bidder then has to give notice of its offer to the public and wait 10 days. When the bidder makes its offer, it has to take pro rata acceptances from all the shareholders who respond during the period in question. So we have the three Ps: the percentage, the pause and the pro rata purchase. This is a sharp exception to the general rules with respect to shareholder transactions, that is, the freedom to buy and sell at will on the basis that externalities do not matter, as in the case of the bushel of wheat.

Easterbrook and Fischel argued that this effort to preserve shareholder democracy in target companies reduced the likelihood of takeover offers. It is expensive to assemble the kind of information that identifies suitable targets for takeover. Even after that information has been assembled, the bidder has to know something about the composition of the target shareholders and their reservation prices and to formulate a relatively coherent plan for managing the assets once the bid has succeeded. If the rules promote some kind of auction, given the pause requirements under the Williams Act 1968, the likelihood of success for a first bid is necessarily reduced. If there is no first bid there will not be any second bid. Thus it is idle to try to create an ideal situation; one has to take into account the incentives facing bidders to begin with. Likewise, if shareholders know that there is a possibility that a raider will come forward, that will increase the underlying share value because there is a conditional option of being able to sell at a premium over market value. This in turn will drive up the market value of the shares. So the appropriate regime is one of commendable legal simplicity: passivity with respect to management and, in the US context, the repeal of the Williams Act 1968.

In contrast, the second scenario mentioned earlier, that management is nimble and shrewd in all things to do with the business of the company and the welfare of the shareholders, presumes the existence of a well-performing company. The bidder will then make an offer on terms intended to stampede the shareholders. It front-loads the offer so that those shareholders who respond quickly get a premium and those who do not miss out. The bidder then forces an appraisal buyout of the remaining shares at something less than the original offer price. Thus the bidder could acquire a company for a weighted price representing the average of the premium price paid for the control block and the lower appraisal price paid subsequently in order to complete the purchase.

This scenario raises the question of whether we should drop the idea of a company comprising many individual shareholders and instead think about this as a situation where shareholders are forced to jump for the raft whether the management is good or bad, when what they would really like to do is coordinate their efforts.

To think this issue through, imagine that all the shares in the company were in fact concentrated in a single shareholder who had received an identical offer to that made in a standard tender situation. What would that sole shareholder do? If you were the sole owner of a complex business or a piece of expensive real estate, would you rush to accept such an offer? Not necessarily. You might sit tight for a while, consider your options, look for other bidders, make counteroffers, and do all sorts of things to improve your bargaining position. On this view, what is really happening in the takeover situation is an insidious strategy of divide and conquer by a bidder intent on acquiring a company for less than it is really worth.

The Easterbrook and Fischel answer is that there is usually a spread between the lowest amount that shareholders are willing to accept per share initially and the highest amount that an acquirer is willing to pay. What happens is that the passive response gives more of the surplus share value to the acquirer without any loss in overall efficiency, and indeed with few distributional consequences if shareholders diversify their holdings. The rival school (which is again driven by the efficiency logic associated with markets) argues that what one should do in these circumstances is organise an auction. The way to organise an auction is to give power to the board of directors (who now by assumption are virtuous) to stop individual defectors from stampeding. The board of directors could then negotiate on behalf of all shareholders collectively, make counteroffers, extend options and so forth. On this view, devices such as a poison pill are simply a way of ensuring that a bidder cannot pick off weak shareholder members but has to come to the board of directors which will aim to get a higher price per share than shareholders would obtain if they decided on the offer individually.

It is not at all obvious to me which of these two tales supplies an accurate description of what we have observed in securities markets. The one thing that is known from the takeover literature of the 1980s is that the acquiring companies did not achieve super-normal returns in these takeover battles and that target companies did fairly well. The analysis is complicated by the dynamics of the complex regime created by the Williams Act 1968 but the competing ideas are clear. How can this battle be resolved in the face of the very considerable empirical uncertainty associated with takeover situations? If we can answer this question definitively, we can then go back and discuss 'pass the parcel' or control block transactions, which would complete the tale.

How might restrictions be imposed on company takeover bids?

If we cannot tell *ex ante* which of the two scenarios is going to apply, we are well advised to abandon regulation and return to contract. We have seen that the usual rule is that shares in an open or public company are freely alienable and we have agreed that it is very difficult to construct a rule that tells us when to pass from the model of free alienation of an individual share to a model that justifies restrictions on alienation of block shares. The difficulty in framing such rules tells us that we need a contractual solution by the shareholders of the public companies who *ex ante* resolve that issue amongst themselves.

How can that be done? There are two methods. Suppose I am about to start a new company – call it Epstein Inc – which will specialise in Microsoft technology on the Internet. I want to have a public offering of shares on the stock market but I think that the probability of an eventual takeover bid is quite high given all the synergies in the telecommunications and computer industries. So I can put forward one of two sets of rules.

The Epstein A Rules provide for a super poison pill. When the bid comes along, all the other shareholders trust me to do the best thing and they have agreed in advance that none will defect and sell out on the cheap. In other words, following a tender offer the other shareholders agree to be blocked and to allow me to see what price I can get for their shares.

The Epstein B Rules effectively concede that while I may be a fine entrepreneur now, in five years' time I might be incompetent or dishonest. So when a tender offer comes, other shareholders can treat it as a life raft and jump ship and there will be absolutely nothing that I can do stop them.

With a little imagination, we can also develop an intermediate position in which everyone agrees, for example, that when a tender offer comes no one will tender shares for five or 10 days. As owner, I will agree not to loot assets or to engage in improper transactions, but I also agree to try to organise an auction by putting the company up for sale. This way we avoid the really destructive actions that could take place but we enjoy the benefits of the auction. At the same time we understand that the auction may reduce the possibility of an initial bid, but we accept that trade-off because we can try to initiate bids ourselves by hiring an investment banker, paying somebody greenmail (inducing them to make an alternative offer) or using other techniques to generate interest in our position.

How can we determine the optimum solution? You can run every thought experiment you like and the conclusion will be that there is no optimum uniform solution. Given factors such as the existing distribution of control, the kind of technology involved, the firm's long-term contracts and so forth, in some circumstances the better solution is arrangement A and in others it will be arrangement B or an intermediate regime.

There are then two ways to proceed. As a policy maker you can act as if you know what the situation is in all companies and ordain one set of rules or another. If I want to list on a particular stock exchange which is subject to statutory regulation or has a uniform code, I am forced to play by a mandatory set of rules. This seems counterproductive, because it is clear that the founders of the company have every incentive to find the set of rules governing future takeovers that will maximise shareholder value because that will maximise their stake in the event of a sale.

So my view is that companies should make their own rules. What the regulator should do is require companies to give public notice of those rules so as to influence both the behaviour of bidders and the prices of shares traded in isolated transactions. What made the issue so difficult in the takeover wave in the United States during the 1980s was that takeovers were previously seen as isolated events and not regarded as an important component of share value. Initial share issues had made no clear provision for takeover. It was therefore necessary to make default rules, and the default rules necessarily had the level of imprecision discussed earlier. That problem could be overcome by allowing companies to amend their constitutions, but there is a vast difference between obtaining unanimous consent to a set of terms in an original issue and modifying the constitution of an existing company with the approval of a majority of shareholders. It is easy in these circumstances to see that a majority vote in favour of approval will in effect be an implicit wealth transfer from one group of shareholders to another. This in turn creates a real tension because we have to decide whether to sanction these sorts of partial changes, which may turn out to be social improvements or may turn out otherwise. We even have to consider whether to require some kind of super-majority vote as found in covenants governing condominium developments and national constitutions. The incomplete initial contracting, in my judgment, created this enormous difficulty.

Once the situation with respect to tender offers is understood, the rest of the analysis is relatively easy. To go back to the question of a 'pass the parcel' control block transaction, the owner of the control block ought to be able to sell it as a single body of shares. In order to acquire those shares the owner had to persuade people to sell and may have had to pay a premium. In addition, the owner of a control block often has to take on the functions of monitoring the company by virtue of the fact that a large enough stake makes it worthwhile to do so. Small shareholders, therefore, far from being disadvantaged, are in the happy position of being free-riders in spite of themselves: they do not have to monitor the board of directors because the owner of the control block will do so for them. If we then say that the returns from that activity will be socialised *ex post* – for example, through an equal pricing rule in the event of a takeover – there will be no inducement for the owners of the control block to perform this monitoring function. It seems difficult to maintain that any premium associated with a control block may be preserved when someone owns it, but that that premium is going to be lost, or shared, if they try to alienate it. If the premium is spread around, the transaction may not take place because there may be insufficient gains to the seller. If, on the other hand, the premium is concentrated in the control block, then the possibility of a beneficial transaction is maintained and the minority shareholders benefit from the superior monitoring undertaken by the owners of the control block.

There are two further reasons why it is wrong to view minority shareholders as losers in 'pass the parcel' transactions.

First, they do not pose a serious prisoner's dilemma problem of the sort we saw in the case of an unregulated takeover of a company with fragmented small shareholdings. With a control block going from A to B, it is not a question of defection, or of waiting for offers. The owner of the control block can set up an auction if desired, but no problems arise which require regulation of the internal company framework.

Second, minority shareholders could protect themselves quite simply by diversifying their holdings. If you are a minority shareholder in multiple companies then in some cases you may not share in the premium arising from a control transaction but in other cases you may get a large premium, again as a free-rider. Nothing beats diversification as a protection for minority shareholders. Ideally investors who wish to be passive would diversify and those with superior monitoring skills would concentrate their holdings.

So the desirable result actually looks rather like the New Zealand scheme, where your Stock Exchange gives issuers a range of listing options, and unlike the American scheme. The optimal approach is to recognise that voluntary contracts are the best way to establish takeover rules, not legislation like the Williams Act 1968. People should be allowed to pick whatever system they want in organising their internal company constitutions. The only criticism I would make of the New Zealand regime is that there are not enough choices on the menu. I agree with Roberto Romano, a specialist in corporation law, who argued on a visit to New Zealand that a further listing option should be one that involves no restrictions at all – call it the 'Wild West' option if you must. It is not at all clear that there would be no takers for such an option. I gather that in New Zealand it is the least well-performing companies that cling to the most restrictive rules on takeovers, and that the restrictive 'minority veto' option has been the least supported in shareholder votes by large and small shareholders alike.

Where have all the hostile takeovers gone?

There is one remaining issue that we cannot ignore, namely what has happened to the corporate takeover movement in the United States; as of early 1999, it seems to have vanished. In the 1990s, I have been able to locate only a few transactions that seemed to have all of the paraphernalia associated with the hostile takeover battles of the 1980s. I believe that of the huge amount of merger activity that has gone on in the United States recently, well over 90 percent by value has been by voluntary acquisition. How should we construe this?

One could suggest that the anti-takeover legislation in the United States has made it so difficult to mount hostile takeovers that the incentives have been eliminated and as a result everybody has suffered a real decline in shareholder value. One argument against that proposition is that the United States has had a booming stock market in the 1990s, which hardly seems consistent with the idea of a diminution in value. An answer may be that many companies are better managed but some are not. To see the effect of the rules we should not look at aggregates; we should segment the market into different kinds of companies and do some empirical research into whether the laggards have been protected against takeover.

The alternative explanation is that takeovers are a costly way of monitoring the quality of sitting management. The idea of discipline by threat of takeover presupposes that owners are essentially passive, given the separation of ownership from control that characterises the modern company. There seems to be some evidence in the United States that this is no longer the norm and that other monitoring practices have come into play, precisely because the takeover bids showed owners just how serious the problem of incompetent management was. One piece of evidence that points in that direction is the apparent transformation in the role of institutional investors like CREF (the College Retirement Equity Fund) and Calpers (the Californian state employees pension fund). These organisations face the challenge of investing large sums of money every month in the stock market. They have to take up holdings in very large companies and they have enough at stake in these companies to motivate them, as institutional investors, to engage in serious monitoring.

The 1980s attitude was that organisations such as pension funds were simply passive and would not pass judgment on the way in which companies operated. Instead they would just increase or reduce their exposures. Today the attitude seems to be different. These types of organisation are investing the savings of a lot of people, they are fiduciaries to their shareholders and pension holders, and they watch company performance much more closely. With greater monitoring by institutional investors, one would predict that even with unrestrictive takeover rules there would be fewer takeovers because of incompetence than before. If in fact management is better than it was before, you would expect to see mergers taking place not to throw the incompetents out, to break up the company and to liquidate its pieces, but rather to exploit genuine synergies which are understood by the acquired company every bit as much as by the acquirer. Those companies wanting to preserve the synergies and acquire the management team have, moreover, no incentive to drive them away by a hostile takeover with a golden parachute.

So the verdict is unclear but I think that it is at least plausible to say that one of the real benefits of the 1980s orgy in hostile takeovers is that it exposed the soft underbelly of American business. Once it was exposed, the mere general threat of takeover was enough to help reconstitute

American businesses in ways that reduced the level of incompetence and changed the internal monitoring structures so that the market for takeovers became somewhat less active, notwithstanding that the rules on takeovers remained relatively unchanged.

Conclusion

Having gone through this rather long and convoluted tale, we can at last approach the larger question that we are facing here, namely what is the ideal takeover regime? I suggested it is possible to come up with a positive but not exclusive answer. When looking at corporate takeovers, control transactions and the like, the important thing is to not be fooled by the apparent similarities of transactions. The fact that large companies are often complex and have different patterns of shareholding, as well as the differences between asset structures, how control blocks work, who the management is, how much knowledge the minority shareholders have and so forth, means that there are sharp differences from case to case. That being so, uniform rules of the one-size-fits-all kind are not going to work well. We have to develop a system that allows for individuation and that in turn requires freedom of contract. The best way to achieve this is through company constitutions and the listing rules of a stock exchange, which should also allow for changes from one regime to another by some form of super-majority vote. This deals with the externality problems without interfering with the operation of the market for takeovers as a whole.

Transactions in private shares, even transactions in control blocks, do not have any of the coordination problems associated with prisoner's dilemma situations, defections, counterbids and so on. So for those purposes I think the New Zealand regime that allows shareholder choice is the optimal approach, although it could be extended to allow companies not to have any rules at all. Small shareholders who seek greater 'protection' can invest in companies that opt for restrictive regimes. If at the time of an original issue shareholders decide they wish to split the premium when a control block is sold, they should be free to adopt such a rule, but the likelihood that they will do so is low. That being the case, my default rule would take an unrestricted form.

Questions

You talked about the alienation of shares in relation to tender offers and how larger shareholdings raise the issue of where there might be restrictions on alienation. I wondered if you had thought about the fact that in the general public securities market there are quite extensive rules aimed at preventing self-dealing by directors or looting of the company which reduce the externality concerns. In that situation is there an argument that you might have a much higher threshold before you start to worry about externalities or even that you do not have to worry about them much at all?

Let me go back and address this concern both as a practical and conceptual matter because I think there is an important distinction to be made. As a conceptual matter, I do not think there is any difference between the case in which you have an outsider making a bid to shareholders and the case in which the bid is being made by insiders who are trying to take a public company private. What I mean by that is that at the time of the company's formation the shareholders should be able to pick a set of optimal rules that govern how management will react to outsiders – where of course there is a conflict of interest and the prospect of a golden parachute – and where they conduct an inside bid involving a more apparent conflict of interest. There is a great deal of similarity between the going-private transaction, which is a self-dealing transaction, and the hostile takeover bid.

The going-private transaction raises the danger that the management can, as it were, buy the shareholders out very cheaply and force the transaction by some sort of coercion. A lot will depend on whether it is a matter of voluntary purchases of shares which could be followed by forced completions of the deal by appraisal remedies, or whether in the wake of the voluntary acquisitions the remaining minority shareholders still have strong property rights. I understand that in New Zealand, as in most places, there is some kind of appraisal buy-out system – indeed this is in fact a requirement of the listing rules of the New Zealand Stock Exchange and is also commonly written into the constitutions of unlisted companies. If shareholders wanted to contract out of such a rule, I would let them do so, in order that they could then require a buyer to negotiate with the holdouts before the entire business could be acquired. Would firms want to contract out of the appraisal system? My own instinct is no. While the holdout transaction may increase the gain that the minority shareholders get from holding out, it will reduce the number of occasions on which the possibility of that gain arises. Even though insiders may think that there are real gains to be made from taking the company private, they may never start down that road if having to deal with that last 10 percent is going to make their life miserable. If you have an appraisal system, the transaction is more likely to occur, and the force-out may take place at a higher value precisely because this option is available to all the shareholders in the company.

Another point never to forget is that, if people are uncertain, they can divide their holdings, offer some of them early in the process to the insiders and hold the rest until the appraisal force-out or in case the deal falls through. This suggests that the usual kinds of trade-offs are at work. Only one rule comes through loud and clear: it is hard to conceive of any situation in which a group of shareholders will allow a forced acquisition of their minority position to take place at an amount that is less than the pre-bid value of the shares. That is, they will take the position that if their shares were worth X dollars before the acquisition commenced, they would expect to get at least X dollars if they were forced out. This situation could be complicated by external developments that cause the entire sharemarket to fall, but at least in principle that is the first benchmark.

The harder issue to be faced is the fairness question and here again there are two lines of argument with close similarities to the sale of the control block. On the one hand going-private offers do not just materialise out of thin air. The insiders have to be making a judgment that there are some gains that they can secure for themselves by taking a group of assets private. It may be that they think that they could capitalise on inventions by having higher levels of trade secrecy, or that they should go overseas to avoid the need for certain kinds of licences that they would require as public companies and so forth. It takes money to make the bid. If you reduce the gains you reduce the probability of the bids occurring. On the other hand, people are very uneasy about a transaction in which all the surplus goes to one side and none goes to the other. If the appraisal buy-out is forced at the pre-bid value, all the surplus goes to the people who are lucky enough to tender and the others miss out.

There is an alternative to forced takeovers. The Mill Acts in the United States which were common toward the end of the nineteenth century dealt with the situation where a landowner wanted to flood somebody else's land to create a headwater from which to run a mill. This had to be done by way of a forced transaction because there was a holdout problem given multiple upstream riparians. That is, unless, say, 20 plots of land could be flooded at once, the project was not viable, so one plot holder could block the entire scheme once it became known. Here we have divided landholdings looking like companies again: instead of shareholdings you have plot holdings. The Mill Acts allowed the forced exchange to take place, but the minority landholders had to be paid a premium of, say, 10 percent over the market value of their land. Now this had a downside. It meant that those transactions that only yielded, say, a 5 percent surplus would not go ahead, given the mandated premium, and everybody was worse off. But if the premium associated with the deal was larger, you would get a slightly more equitable distribution of the benefits and that in turn might induce people to invest in this kind of venture to begin with. With shareholdings the same decisions about rules have to be made. I think the freedom of contract approach is the right general solution; what is not clear to me is whether we should introduce additional shareholder protections.

The requirements in the New Zealand Stock Exchange rules for independent appraisals are based on a fairness principle. If this implicitly arises out of contract there can be no objection. State regulation, however, may be motivated in New Zealand by an excessive sensitivity to criticism that it could otherwise be seen as a 'Wild West' jurisdiction. In this case political considerations may wrongly be given more weight than commercial logic. I cannot conceive of any set of imposed substantive terms that ought to override unanimous shareholder consent at the time of the formation of the company.

There are certain circumstances in which a hostile public tender offer is a less efficient form of transaction than creating a closed company. Inside information, trade secrets and the like retain value only to the extent that they are not disclosed. If owners are attempting to go private, they may find a way of buying out the shares without having to disclose this information to the world, so it remains a valuable asset in the hands of the company after it goes private. Even if allowing that practice is wrong for reasons that I do not understand, the basic intuition is that if there are multiple ways in which shareholders can get out of an investment, that increases their liquidity which increases their willingness to invest in the first place. So my instinct is to apply the same freedom of contract conceptual framework to the going-private transactions that would apply to the hostile takeover. As with the control block transaction, however, I think it is unlikely under most circumstances that shareholders could be induced to sell for less than the pre-bid price, and this observation will apply so universally that it is tantamount to an exchange rule. Thus we have a kind of strong normative prior with going-private and control block transactions that we do not have with respect to the tender offers.

The world I have described is one which treats a company as a network of contracts amongst its shareholders in which they are trying *ex ante* to optimise the value of their investments. If you know there is an optimum solution that applies in all situations, you may as well make it a coercive rule. If you doubt that, then you ought to allow freedom. In New Zealand the freedom of contract approach seems to be much more powerfully embedded with respect to outsiders than it does with respect to the insider transactions. I am questioning the wisdom of that because I think that there are conflicts of interest inherent in both situations and that there is no good reason to differentiate them from a regulatory point of view.

Is it not also the case that fiduciary duties in the law or the company constitution will help protect the interests of shareholders?

A strong set of fiduciary duties is certainly important. At the same time, the problem with a fiduciary duty is that if you make it too strong it creates immobility for fear of liability and you not only block bad transactions but good transactions as well. The only matter that is distinctive about companies is limited liability, and since we are not talking about tort claims the company does not have any separate metaphysical status that is worthy of attention. The advantage of being a contracts lawyer is that your mind does not get cluttered by these other factors and you start looking at the company as a kind of pure contractual transaction.

Is there any empirical evidence to suggest that companies that have large block shareholders are less prone to hostile takeovers?

This is not my area of expertise, but many public companies today do have large shareholding blocks. The idea that public companies are all thinly held and that everybody has 100, 200 or 1000 shares is wrong. The single block holding will reduce the need for takeover activity as it gives effective working control. There is good reason to believe that these blocks survive only because of their monitoring function. Otherwise you could not explain them because there is risk in non-diversification. I suggested that block shareholding was one of a variety of mechanisms by which mutual funds and institutional investors had changed the constitution of the market from what it was in the 1980s. Their own new internal policies make takeovers less imperative, even if the possibility of hostile takeover is still there. Monitoring through large blocks, appointing directors or publishing unfavourable material in the media is a lot cheaper than starting a takeover fight which could cost tens of millions of dollars to litigate and have an uncertain outcome. We also now know that takeovers tend to produce surpluses for the target company but only normal competitive returns for the bidder and if that is so, there will be a lot of eager victims but not a lot of eager assailants. But these issues arise in all markets. We have to figure out what the *ex ante* perspective ought to be and if a transaction is going to maximise expected shareholder value, the fact that *ex post* it tends to give unequal gains is simply a reflection of the different risk strategies different individuals adopt, rather than a sign of fundamental unfairness. Unfairness is an *ex post* concept; we should examine these transactions *ex ante*.

I wonder if you could tease out your argument that alienation of shares may be different from selling a sack of potatoes, because I am not entirely convinced. Why should there be restrictions on alienation as opposed to simply acknowledging that investors holding shares are recognising and accepting as a risk that there may well be a change of direction in the company at some stage, whether through a change of management or in some other way?

I think the conceptual difference between the two situations is clear. Owning a sack of potatoes does not give you claims against another asset and it does not put you in collective governing situations with other individuals. It would be no different if there were a silo of wheat in which you had a fractional interest that you then assigned to somebody else.

Assignments are usually unfettered to the extent that the sole right that you have is to dispose of a fractional amount of a fungible commodity. There are no externalities involved so you get all you need in the form of a warehouse receipt. But the moment there are management functions, for example, the situation changes. So if you want to assign a fractional interest in an oil well, where decisions about drilling or not drilling will influence the yield, people are going to be very concerned about the choices made.

From the legal point of view, the share alienation is in principle different from the wheat alienation by virtue of these corporate governance issues. The next question is what you do about that. One solution is to say that you assume the risk of those changes when you buy the share. But that means that there is a cost associated with a benefit and my argument is that if the cost starts to get too large, somebody is going to try to minimise that cost by having a series of *ex ante* contracts amongst the shareholders that clarify what happens when companies switch regimes. The basic intuition is that so long as the share transaction is a non-control transaction between one passive owner and another, it is like the assignment of the warehouse receipt with respect to the wheat. But the moment it turns out that the purchaser is going to be an active user of that particular claim and ask for a seat on the board of directors, you have a new situation. You can decide to opt for this regime and take your chances or you may decide not to do so and not to take your chances, and there is no way that government authorities or regulators can decide uniformly which is the better regime.

Will a contractual approach get it right all the time? No. There will be a certain error rate because shareholders have to try to figure out *ex ante* what may happen in an environment where there may be radical changes in product technology, tariffs, legal rules, international transactions and so on. This is why the possibility of reversal through another set of rules may be advisable, and that option too can be addressed by provisions that specify what hurdles must be run to amend the basic charter.

All of this is consistent with what we know about alienation of other kinds of interest, for example water rights. Legal regimes are very careful about allowing the free alienation of water rights (when unattached to land) because the moment rights are withdrawn from the common pool there will be effects on other individuals. So the first rule with water rights is that you cannot assign them to a non-riparian because at that point you cannot control the quantity restrictions as you could in the traditional situation. The externality counts. Under a more complicated regime of prior appropriation, you can have a rule by which I withdraw X amount of water at a point upstream or X amount of water downstream. There is a vast difference between these positions because even if the stated priorities are the same, the further upstream you are, the more likely it is that you will take water that belongs to somebody else and all the intermediate riparians will be upset about this transaction. Another illustration is a queue. If you take my place in a queue for movie tickets, might that give rise to an externality? The answer is certainly yes if I were planning to buy one ticket and you were buying four – those further back in the queue may be affected. The situation is even worse for them if I just let you go in front of me as a favour. This gives rise to informal or formal rules about queues. So it is with any of these alternative arrangements for alienability. The company situation is simply governed by the general principles that handle some of these other transactions.

It strikes me that the assumption you are making is that the content of property rights includes control and I wonder whether the separation of ownership and control doesn't have a more normative aspect to it.

What I assume is that typically a property right in a share involves the following set of rights: a right to some dividend claim, usually on a pro rata basis, a right with respect to liquidation, and a right to a vote. Each of these rights could be traded separately and you can concoct shares which give you one or two of them but not the third. What is interesting about the vote, by analogy with political theory, is that it may look to be colourless, odourless, tasteless and homogenous but if you amalgamate your vote with the votes of other individuals in coalitions, some votes are worth more than other votes. For example, if you get a 51 percent majority in a first-past-the-post system your votes count a lot more than those making up the other 49 percent. With a proportional representation system, the 2 percent block at the middle with two 49 percent blocks has enormous power. In the corporate context when you put two votes together, the same kind of synergies – that is, A plus B is worth more than A and B separately – will occur. That is always a source of anxiety, because it means that mergers under these circumstances could have profound external effects. The issue then is whether you could or should prevent this from happening.

If you were worried about these synergies you could have a restriction to the effect that no individual may directly or indirectly own more than, say, 5 percent of any given company so that you create an environment where there is no control block. But if I am right about the externalities, this step could be a little premature because the externalities are not only negative – in that block shareholders will determine the composition of the board, the direction of the company and so forth – but also positive. Those shareholders may now monitor the company, and do a very good job of it, and they may also keep other small shareholders from messing around in the company's affairs.

With limited real estate partnerships, the single most important selling point is that you can be partners with people you do not know and do not trust, because they have no ability to take over the business from the general partners in whom you have confidence as an investor. On this analogy there may be a market for restricted share ownership and control. However, my own instinct is that if you ask most shareholders whether they want to have a democracy of small voters without any concentration of power, most would vote against that because they would think that, on balance, the positive externalities from the creation of a control block are larger than the negative externalities associated with it.

What makes the issue difficult to analyse is that the cash claims are strictly additive – double the number of your shares and you double your dividends and double the liquidation rights – but the voting claims are synergistic in all sorts of complicated ways and raise the possibility of coercion. 'Coercion' here simply means there is a prisoner's dilemma game in which the total value received by the shareholders under a tender offer is less than it would have been with some *ex ante* rules determining how value would be divided amongst the shareholders. You could take the position that an equal sharing rule should be disallowed because it would minimise takeovers and add negative externalities to the economy. But because it is not clear to me which way the externalities run, I would be loath to take that position as a matter of statute. On this argument, I should not be allowed to make a contract to sell my labour to A because there is an externality with respect to B. It is better to rely on voluntary contracts and the density of markets to handle the externality problem.

What you seem to be demonstrating, and it is an idea that I find attractive, is that the concept of property is just a shorthand term for a lot of different kinds of rights and it is a bit of a dangerous concept because it leads to the fallacy of regarding the sack of potatoes as being the same as a share. If you could strip away that language and use different terms to describe these different relationships, a lot more clarity might be brought to the subject.

I am generally sceptical about suggestions that terminological confusion is so irreducibly great that we have to eliminate some terms altogether. What I would say is that property has two essential features. One of them is the original acquisition rules and the other is the transfer rules. What is an original acquisition rule? One of the things that people do not spend enough time in property classes studying is how somebody gets to own a sack of potatoes in the first place. It is quite clear that the answer is not by purchase because then you have to figure out how somebody got the right to be a seller, and the usual maxim is that you have to be an owner before you can be a seller. The standard answer is that property was initially acquired by seizure. This, of course, is a rule of debatable merit because of the externalities on others who are excluded by virtue of your claim. So William Blackstone thought property was the most wonderful thing in the world and Pierre-Joseph Proudhon thought that it was theft.

Leaving aside the justification for the moment, what counts is the clarity associated with the term. The common law and every other legal system has an unambiguous preference for composite bundles that cover all rights. They do not create fractional interests in anything by virtue of an original possession rule. That means in the case of land that you get it in fee simple, and it runs in perpetuity. The property right in land extends from the centre of the earth up to the sky. These very powerful and usable rights permit sensible exploitation of land for purposes such as cultivation or building. If acquiring land meant that I could do nothing above or below it, I would have only a two dimensional right. I would have to worry about people claiming use rights above or below the ground, resulting in transactional nightmares. Bundles are therefore created to allow efficient use and disposition of property. Once you have a bundle, you then create divided interests by contract in the same way that people in financial markets create complicated capital structures. You can create a life estate or a lease and then a mortgage and an option, and go on to create a sublease and a second mortgage and so forth. These are all property, in the sense that they are protected from expropriation by strangers. Each of the people involved in this contractual web can exclude the rest of the world, as did the single owner beforehand, but the rights are determined not by an original acquisition rule but by a contractual rule. So we use the word 'property' for these interests because they are exclusive. The reason we have to be careful is that we have to recognise their contractual origin.

When you are dealing with companies you are never dealing with an original acquisition. A company is a joint venture between individuals, which means that there is a pooling arrangement and a common ownership and that you are always dealing with the second situation, contractual origin. What is the right way to understand it? As against a trespasser, the several shareholders are as one and can exclude a stranger, recover the property if a stranger takes it or demand just compensation from the state. So that is why we call it property. We must then distinguish between holders of different rights in the same property whose relationships are contractual, and their relationship with strangers, which is not contractual. We need the term 'property' to protect shareholders from trespass and similar risks, but we must also recognise the sack of potatoes fallacy.

This situation, of course, is not unique to companies. The land and chattel paradigms are not the only paradigms that work with respect to property. When I teach a property course, I spend time on those paradigms but equally I devote time to such questions as how property rights are created in things like oil and gas, running water and ground water, mineral claims, the radio spectrum and information.

It turns out that Blackstone's simple model of property does not work for all these assets. Not only are there differences in the contractual dimension but even the original acquisition rules are resource sensitive. Why? We have to go beyond the land case to develop a transactional theory that handles more complicated bundles of rights in such a way as to maximise the expected patterns of benefits from use and disposition. This explains why rights involving limited periods of time make sense for copyrights and for patents, and why the periods of time differ. It also explains the rules that we find applying to trademarks, trade secrets and the like. I think I would rather keep the terminology of property, use it to discover the elements that are in common, such as protection against external confiscation or takeover, and then use the distinctions to help people understand the characteristics of the different varieties of property.

Then one of the things that you discover is that for certain kinds of land it is very rare to create divided interests, except by way of lessor and lessee, or secured lender and equity holder, because it is just too inefficient to do so. Almost no one, for example, purchases life estates in private homes. What needs to be recognised is that just because something is called property that does not mean that the set of rules that should apply is uniform across different categories of assets.

There is surely a need to distinguish between the rhetoric about property as it applies to land on the one hand and to shares or intellectual property on the other?

There are distinctions, but also common features. That is, suppose you say that "this property is only shares and therefore the government can take it over at will". That is a bad outcome because the unwillingness to call the rights to these shares property means that there is no protection against the eminent domain power. A realistic example is rhetoric like "Well, it's only a company so when we take from it we are helping people and we are only hurting some legal entity". Once you recognise that the company is really only a collection of individual owners, taking from A and giving to B is a bit more ominous. There is no question that state regulation of corporate behaviour is made easier than it ought to be by virtue of the fact that the people who are regulated are in some sense impersonal whereas the people who benefit are really very tangible. The point that should be emphasised is that every regulation of a company is a disruption of a contractual relationship. That in itself ought to give rise to some considerable pause and the burden should be placed on those who advocate regulation to justify its net benefits.

There are elaborate contractual provisions in leases that deal with how you divide the proceeds between landlord and tenant when the government expropriates. I have worked on a number of fairly complicated cases where strategic takeovers by the government were designed to destroy the value of the lessee's interest. The real issue in these cases was whether or not an invited takeover by a government agency should be treated as an expropriation so that the landlord keeps all the money and the tenant walks, or as an assignment of a lease in which case the tenant keeps the premium value associated with the property. This is not just a question of rhetoric. Hundreds of thousands of dollars can turn on that question. I have no scepticism about the language of property.

The simple rule of thumb to start with is that property is good against the rest of the world, regardless of the complexity of the internal ownership relationships, but it is weak in describing relationships between co-owners for which contractual approaches are more useful.

When you were using the language of property in the takeover context, an issue that you did not cover is the position of management. Do you think their position should be simply one of passivity in the event of takeover?

No, I do not. I think the answer is to go back to a contract rule. Without any legislative intervention, a private individual's employment contract is presumptively at will on both sides. This means that neither side has a property right except to the extent that they have the right to the accumulated labour or wages for the period in which the contract is in existence. You can look at term contracts that do create property rights. What rights do they create? Either they create rights to cash flows from the position or to specific performance. We do not want specific performance enforced between individuals when that would require their unwilling cooperation. Hence the common law rule is that if, as an employee, you have a term contract that is terminated, you are entitled to some compensation by way of lost salary, and maybe even damages for loss of reputation, but you cannot keep the position.

There is an issue of the payout that ought to be made to a chief executive officer in an acquired company who loses that position after a takeover. My view is that this should be explicitly negotiated as part of the employment contract and approved by the directors or shareholders. This will lead to some odd situations: "We believe you may turn out to be an incompetent manager, but we will give you a golden parachute". *Ex post* it looks at though you are prepared to reward non-performance, but *ex ante* what you are doing is paving the way for an easy takeover by giving the chief executive a million dollars and giving shareholders the prospect of earning a hundred million dollars. That is not a bad deal, especially as the target company would have been stuck with this manager if there had been no takeover.

Thus, as we have seen before, the principle is to start with simple default rules but as the stakes become higher the negotiations must become more explicit to ensure that the *ex ante* provisions for any subsequent contingencies are sound. Financially speaking, an employment contract is a lien on the capital structure of the business which is subsequent to that of debt holders in most cases but prior to that of equity holders. We have to decide whether the optimal condition is one in which the size of that lien is constant, regardless of the future fate of the company, or whether it ought to be liquidated or varied in certain circumstances. With low level employees, it is not a major issue because they do not have control roles. For them, we typically have severance packages based on multiples of years employed. But for senior executives who can influence the fortunes of the company, we have to have a greater level of individuation and we should apply the same principles as in the takeover analysis. *Ex post* unfairness is not the same thing as *ex ante* irrationality. You have to look at the transaction from the beginning and see whether or not the conditions make sense, and if they do you should be very reluctant to override them by way of regulation. Although I did not talk about the compensation package of managers, I think it can be analysed quite neatly within the framework I outlined.