Takeover Regulation in New Zealand: Policy for Competitive Advantage

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I: INTRODUCTION**

New Zealand business increasingly competes in international product and capital markets. Consistent with this trend, the economy has been restructured. It has become open and deregulated with the goal of upgrading New Zealand's competitive advantage in world markets. Corporate governance determines part of that competitive advantage. The terms of the corporate contract[1] offered to investors are priced in capital markets.[2] If a term is unfavourable, it reduces the price which investors will pay for corporate securities, this means that the cost of capital is higher, and the company suffers a competitive disadvantage.

Legislation forming part of the corporate contract of every company affects the entire economy as there is no choice of corporate codes in New Zealand.[3] If mandatory legislative terms are sub-optimal, each company's ability to compete in

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** At the time of publication the Takeovers Bill 1991 formed part of the proposed Companies Law Reform package, however its continued inclusion was under review.

1 The term "corporate contract" refers to all of the terms in the nexus of contracts between investors in the company: the corporate constitution, the companies, securities and takeover legislation, and the contractual terms of any securities issued.

2 Symposium, "The Structure and Governance of Enterprise " (1990) 27 J Fin Econ 1; Symposium, "The Distribution of Power among Corporate Managers, Shareholders, and Directors" (1988) 20 J Fin Econ 1.

3 Compare the situation in the US where a company can choose to incorporate in any state, and so has a choice of over fifty codes.

international capital markets may be impaired. Takeover regulation is one element of the corporate contract. Thus, it is important to adopt a regulatory policy towards takeovers which promotes the competitive advantage of corporate New Zealand.

Takeover regulation has been the subject of fierce international debate for over a decade. During the 1980s, merger and takeover activity reached previously unmatched proportions.[4] In the United States, hostile takeovers received widespread publicity as numerous groups perceived a threat to their interests. Emotive claims were made that the "corporate raider" was busting apart wholesome corporate citizens, displacing jobs, smothering research and development, damaging industrial competitiveness, and leveraging the future of corporate America. After all, this was the decade of the myopic profit when corporate raiders believed that "greed is good".[5] The language of the takeover specialist became no less colourful as the US entered "the era of the two-tier, front-end loaded, bootstrap, bust-up, junk bond takeover".[6] The terms "golden parachutes", "greenmail", "crown jewel defences", "chills, pills and standstills", "white knights", and "pac-man defences" appeared in daily newspaper accounts of the fights on the corporate battlefields.

In New Zealand, the debate gained momentum following the controversial Lion-Nathan merger and the 1987 share market crash which fuelled calls for widespread reform of companies and securities legislation. The disclosure requirements in Part II of the Securities Amendment Act 1988 affect takeover practice, although the Companies Amendment Act 1963 contains the main body of existing takeover regulation.[7] This Act specifically addresses takeover offers. However, it has proved easy to avoid. The process of reforming this legislation culminated in the Takeovers Bill 1991 ("the Bill")[8] and the Draft Takeovers Code ("the Draft Code"), recently released for public comment.

This article questions whether regulation of New Zealand's market for corporate control is desirable, and if so, what the nature of a takeovers code should be.[9] There will also be a discussion of the regulatory response contained in the Draft Code.

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4 The total value of US assets which changed hands in the 1980's exceeded US$1.3 trillion: Shleifer & Vishny, "The Takeover Wave of the 1980's" (1990) 249 Science 745.

5 Michael Douglas as "Gordon Gekko", *Wall Street* (Twentieth Century Fox, 1987).

6 Lipton, *Wall Street Journal*, 5 April 1985, 16.

7 Acquirers of more than five per cent of the total share capital must disclose their holdings (including nominee holdings) and subsequent dealings (increases or decreases of more than one per cent thereafter). An important source of private regulation is Section 9 of the Listing Requirements of the New Zealand Stock Exchange, *NZSE Listing Requirements*. This constitutes a takeovers code of limited scope. It is purely contractual in nature and only applies to takeovers of listed companies by other listed companies.

8 As reported back from the Justice and Law Reform Committee to the House of Representatives on 1 April 1993.

9 The focus will be solely on the regulation of bidders. Takeover defences and the fiduciary duties of directors will not be addressed.

II: EFFICIENT MARKETS, THE PRICING OF SECURITIES, AND THE USE OF EMPIRICAL EVIDENCE IN THE TAKEOVER DEBATE

Many claims made in the takeover debate can be tested empirically to determine their accuracy. Therefore, empirical evidence can play a valuable role in guiding regulatory policy. The importance of the economic evidence is related to the way in which securities are priced in an efficient financial market.

The efficient market hypothesis argues that "[i]n an efficient capital market, prices fully and instantaneously reflect all available relevant information."[10] This merely implies that all publicly available[11] information concerning the value of a security will be impounded in the current market price. The value of a company equals the present value of the residual stream[12] of expected future cash flows earned over the life of the firm. When new information relevant to the assessment of future cash flows is released, there is an instantaneous and unbiased[13] adjustment in the market price. Therefore, the market price is an unbiased estimate of the true or intrinsic value of the firm. That estimate constantly changes as new information becomes publicly available.[14] An overwhelming body of evidence supports this hypothesis.[15]

Empirical studies measure the effects of takeovers by examining share price changes around the date of the takeover, or its announcement. In an efficient market the share price movement is an unbiased estimate of the change in value due to the takeover. Share price changes are not merely "paper profits and losses". They imply that market participants consider that fundamental changes have occurred in the prospects for future cash flows. By offering a premium over the market price, it is implicit that the bidder can either generate greater gains from the corporate assets, or commit some form of abuse of the corporate contract so that the premium can be recovered by a wealth transfer from other investors.

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10 Copeland & Weston, *Financial Theory and Corporate Policy* (3rd ed 1988) 331.

11 This is the semi-strong form of the hypothesis. It would not preclude insiders with access to price sensitive information from earning abnormal returns by trading before the information is made publicly available.

12 Equity holders receive cash flows in the form of distributions, and a share in the assets remaining on liquidation (subject to prior claimants such as debt holders, employees, and the Revenue).

13 Unbiased does not mean accurate in hindsight. It means that there is no systematic bias in the market adjustment and hence it will be impossible, on average, to consistently generate profits over time from adjustments in the market price which are perceived to be incorrect.

14 A systematic bias in the market estimate of the true worth of a share results in a profitable arbitrage opportunity. Capital market efficiency relies on arbitrageurs who identify prices that are misaligned, then trade in order to make a profit, thereby reducing prices to a level consistent with available information.

15 See Brealey & Myers, *Principles of Corporate Finance* (1991) ch 13; Copeland & Weston, supra at note 10, at ch 11.

III: THE TAKEOVERS BILL 1991

Parliament has abdicated its power to resolve many of the issues relating to takeover regulation through legislation. The Bill merely establishes a Takeovers Panel ("the Panel") for the purpose of formulating and recommending rules in the form of a takeovers code, and administering and enforcing that code.[16] The Panel has a wide discretion to determine the nature and content of the rules, the scope of their application, and to define the transactions which constitute a "takeover".[17] The Bill even fails to provide any clear guidance as to which policy goals should be paramount in devising a code. Ratner was justified in describing the Bill as a piece of "Clayton's Legislation":[18]

> The Bill is nothing more or less than a complete delegation of legislative authority upon a panel of persons who, whatever their qualifications,[19] have been neither elected nor endorsed by any sector of the populace or the market place .... [Clause 11A] of the Bill, which sets out the objects which the Panel should observe in formulating the code, is about as useful as telling the Panel that the objective is to draft a 'good' code.

Clause 11A(1) sets out the objectives for drafting a code and clauses 12 and 13 contain a number of specific issues which the Panel must consider. However, it is difficult to examine the specific issues in light of these objectives because they encompass most of the arguments advanced by both sides of the takeover debate. Moreover, some objectives conflict with others, and the weight to be ascribed to any particular objective has been left to the Panel's discretion.[20] For example, proponents of a mandatory bid rule would argue that such a requirement deters inefficient takeovers (objective (a)) and ensures that the premium for control is shared equally, and therefore fairly, among shareholders (objective (c)). Opponents would argue that such a rule deters efficient takeovers (objective (a)), decreases competition in the market for corporate control (objective (b)) and increases compliance costs (objective (f)). Each side would argue that its position encourages confidence by international investors in the New Zealand market (objective (d)).

The Panel must also have regard, so far as practicable, to the harmonisation of Australian and New Zealand business law consistent with the principles of the 1988 Closer Economic Relations agreement ("ANZCERTA").[21] However, the Bill does not clarify how important this goal is in relation to the other objectives in clause 11A.[22]

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16 Clauses 4(a), 4(c), 11, and Part III.

17 Clauses 4(b) and 13.

18 "The Takeovers Bill 1991: the case of the missing legislation" (April 1992) Law Talk 367, 7, 9.

19 Clause 6 requires the members of the Panel to be, in the opinion of the Minister of Justice, qualified or experienced in business, accounting, or law.

20 Clause 11A(2).

21 Clause 14.

22 Clause 5(a)(vii) of the Memorandum of Understanding on the Harmonisation of Business Law identified takeover law as one area where harmonisation by co-operating to reach a uniform code would be desirable.

In effect, the Panel must resolve all of the key policy issues in the takeovers debate. It bears the burden of attempting to please a commercial community which, according to Ratner,[23] is almost evenly divided on the matter. In addition, the Bill does not address the question of whether regulation is needed at all:[24]

> [W]e [may] end up with a whole lot of detailed rules that people will be delighted to enforce but that will not necessarily advantage either the business community or shareholders .... The Panel is simply being handed a blank cheque.

IV: THE DRAFT TAKEOVERS CODE

The Draft Code has been released for public comment by the Takeovers Panel Advisory Committee. The Draft Code regulates the acquisition of "voting rights" in a "Code company". "Voting rights" are currently exercisable rights to cast a vote at a general meeting.[25] Voting rights may be attached to any "equity security", which is defined as any interest or right to participate in the share capital of the company, including an option.[26] A "Code company" is a company listed on the New Zealand Stock Exchange, or which has been listed within the previous twelve months.[27] By focusing on the acquisition of control in target companies, the Draft Code will apply to any takeover of a public listed company, notwithstanding that the acquisition vehicle may be a private company, a trust, an individual or any other entity. It is not permissible to contract out of the provisions of the Draft Code, even by a provision contained in the corporate constitution or by agreement between all of the members of the company.[28] The main features of the Draft Code are a mandatory bid rule, equal pricing provisions, and pause and publicity regulation.

1. Mandatory Bid Rule

A mandatory bid rule requires a shareholder with a specified threshold percentage of the total shares in a company to make an offer for all or part of the remaining shares. Termed "the fundamental rule", it prohibits a person, either individually or together with associates, from acquiring or controlling more than twenty per cent of the voting rights of a Code company.[29] A person who already holds or controls more than twenty per cent of the voting rights of the company is prohibited from increasing that percentage holding. The Draft Code then specifies clearly defined exceptions to this rule.[30]

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23 Supra at note 18, at 9 and 11.

24 521 NZPD 6350, 6354 (17 December 1991); see also the Minister of Justice at 6352.

25 Votes which are only exercisable in special circumstances are excluded: Rule 1.

26 Rule 1.

27 Ibid.

28 Rule 23.

29 Rule 3.

30 Rules 3 and 4.

First, the rule does not apply where an offer to the shareholders of the target company is made in compliance with the provisions of the Draft Code ("a Code offer"). Secondly, any acquisition or allotment which would otherwise contravene the rule is acceptable if approved by an ordinary resolution of the company. The acquirer's identity (and the seller's where the shares are not allotted by the company), the price at which the shares are acquired, the reason for the transaction, and the significance of the resolution under the Draft Code must be disclosed to shareholders prior to that meeting. The acquirer and its associates may not vote. Thirdly, the Draft Code allows "creeping purchases" of not more than five per cent in any twelve month period if the bidder holds or controls more than fifty per cent, but less than ninety per cent, of the total voting rights in the company.[31] Fourthly, there is no restriction on acquisitions once a ninety per cent holding has been acquired or is controlled. This reflects the compulsory acquisition rule which requires a shareholder ("the dominant owner"), within thirty days of acquiring more than ninety per cent of the voting rights, either to compulsorily acquire the remaining shares or to give the minority shareholders a right to have their holdings bought out.[32] The consideration in a compulsory acquisition or buyout must equal that offered under any preceding takeover bid by the dominant owner, or must be fixed by an independent expert.

The mandatory bid rule applies to acquisitions conducted jointly by two or more associated parties. One person is associated with another if:

(i) the two persons are acting jointly or in concert;
(ii) the first person acts, or is accustomed to act, in accordance with the wishes of the second person;
(iii) the two persons have a business, personal, or ownership relationship such that they should, under the circumstances, be regarded as associates; or
(iv) the first person is associated with a third person who is in turn associated with the second person by reason of the provisions of (i) to (iii), and the nature of the relationships between the parties is such that the first person and the second person should, in all the circumstances, be regarded as associates.[33]

It is clear that the definition of associate is very broad and would include a syndicate or concert party jointly making a bid. The definition is also open-ended and the Panel retains a discretion to control the scope of the categories of persons who will be considered associates. Similarly, the definition of "control" in relation to a voting right is when a person has, directly or indirectly, effective control of the voting right.[34] "Effective control" and "indirectly" are terms which are left to the discretion of the Panel to define in relation to specific cases.

31 The Panel must be notified of incremental increases or decreases of one per cent of the voting rights: Rule 18.
32 Rule 20.
33 See Rule 2.
34 Rule 1.

2. Code Offers and Equal Pricing Provisions

Without obtaining the consent of the company in a general meeting, the only method of acquiring control is by making a Code offer. The Draft Code permits an offer for all of the outstanding voting securities ("a full offer") or part of them ("a partial offer").[35] However, partial offers must be for a sufficient number of securities, and conditional upon the receipt of a sufficient number of acceptances, to increase the bidder's holding to more than fifty per cent of the voting rights in the company after the acquisition, unless a lesser percentage is approved in general meeting.[36] An offer may not be subject to any conditions which depend on the judgment of the bidder, or the fulfilment of which is controlled by the bidder.[37] This allows a bidder to protect its interests in the case of changes to the target company, statutory approvals, or other events outside the control of the bidder which are prerequisites to the offer proceeding. Therefore, the Draft Code prohibits offers which amount to little more than an option and ensures that control will pass. This implies that the price offered must include any premium paid for the transfer of control. Once made, an offer cannot be withdrawn.[38]

The Draft Code also contains a number of provisions which insist on equal treatment of all shareholders. Rule 8 requires an offer to be made on identical terms for all of the equity securities belonging to the same class. This would prevent a two-tier bid. In the case of a partial offer, there are detailed rules which insist that every holder of a voting security has the right to participate in the bid, by selling the same percentage of their individual holdings to the bidder.[39] Where there are different classes of voting securities, the consideration offered must be "fair and reasonable as between the classes" and verified as such by an independent adviser approved by the Panel.[40] An offer may be varied to increase the consideration or add a cash component to it.[41] However, there is an escalation rule which requires any increase in consideration to be paid for all the shares acquired, regardless of whether a shareholder accepted the offer before or after the variation.[42] Acquisitions for cash may be made outside of a full offer for cash, or with a cash alternative, in very limited circumstances. However, if the consideration paid exceeds that specified in the offer, the offer is deemed to be varied so that all shareholders receive the higher consideration.[43]

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35 Rules 5(1) and 6(1).

36 Rules 6(2) and 9.

37 Rule 15.

38 Rule 12.

39 Rules 6(3) and 10.

40 Rules 5(3), 5(4), 6(5)(b), and 7.

41 Rule 13(1). Note that the consideration cannot be decreased.

42 Rule 14.

43 Rule 17.

3. Pause and Publicity Regulation

A Code offer is subject to rules which decrease the speed at which a takeover may proceed ("pause") and require disclosure of information about the offer to security holders ("publicity"). Notice of the takeover containing prescribed details of all offer terms must be sent to the target company between fourteen and twenty-eight days prior to the offer.[44] The Stock Exchange and the Panel must be notified, and the target must prepare a statement containing prescribed information to be included with the offer or sent directly to the shareholders. All expenses incurred by the target in relation to the offer, or by its directors on behalf of and in the interests of shareholders, may be recovered from the bidder.[45]

In addition to all of the terms and conditions in the offer, important non-public information which must be disclosed in the offer includes:

(i) special arrangements, special relationships or interests of the directors or management, including compensation agreements or financial assistance between the bidder and the target, target directors, or target management;

(ii) a statement by the bidder of the likelihood of any material changes in business activities, financial structure, employment, or ownership and use of assets of the target or its subsidiaries;

(iii) a statement by the target directors, with reasons, recommending acceptance or rejection of the offer. It may state that a recommendation cannot be made or that their recommendation is delayed and that shareholders should not accept in the meantime;

(iv) any actions taken or proposed by the target in response to the offer, including mergers, acquisitions, divestments and changes in dividends or corporate policy; and[46]

(v) details of rights attaching to issued securities, and future prospects for the target in the directors' opinion, including calculations and assumptions underlying any forecast or asset valuations.[47]

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44 Rule 21 and the First Schedule.

45 Rule 22.

46 Defensive tactics are prohibited unless shareholder consent in a general meeting is obtained: Rule 19.

47 See the First and Second Schedules.

V: REGULATORY POLICY AND THE TAKEOVER DEBATE

1. Approach to Takeover Regulation

A company is a voluntary nexus of contracts. The stakeholders include employees, managers and directors, equity investors, debt holders, and holders of options and legal claims against the business:[48]

> The corporation is a financing device and is not otherwise distinctive. A corporation is characterized by a statement of capital contributions as formal claims against the firm's income that are distinct from participation in the firm's productive activities.

Arrangements between these participants are potentially just as diverse as the sizes, organisational structures, objectives, and industries in which different companies are involved. The contractual nexus or "corporate contract" which suits each set of stakeholders will differ from business to business and across time. Sub-optimal terms in a corporate contract are priced in capital markets. The process of natural selection among companies competing in capital and product markets will act as an incentive to eliminate terms of the corporate contract. Those companies that resist change will suffer a competitive disadvantage and may eventually fail. Only those that adapt will prosper. Voluntarily adopted terms that withstand the test of evolutionary pressure are most likely to approximate optimal corporate contracts.

The stakeholders have stronger incentives to construct a corporate contract which best serves their interests than a legislature with no stake in the company. Nor is it likely that a legislature will be able either to draft a single code to suit the diversity of all businesses, or to alter the terms in a timely manner as needs change. This applies equally to regulation of the market for corporate control. If a company wishes to adopt terms regulating the manner in which a takeover may be performed, then it can do so in its corporate contract. External regulation is needed only where the voluntary contracting process may fail.

Therefore, the approach to takeover regulation in this article is that the stakeholders directly involved in the market are best able to determine optimal takeover policy for themselves. Regulation must be justified on the grounds that it effectively addresses a clearly established defect in the market for corporate control:[49]

> Although [takeover] legislation, in one form or another, is relatively common, the objectives of such legislation are not necessarily clear. Firstly, what are the problems that exist in the market, and secondly, if there are problems, why is specific regulation needed to fix them rather than letting the existing general and companies law coupled with private economic arrangements sort it out? In other words, can it be demonstrated that the market has failed to produce the optimal solution (market failure) and therefore regulation is needed to solve it? If market failure can be identified, it should be clearly established that the benefits of regulation would outweigh the costs.

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48 Easterbrook & Fischel, *The Economic Structure of Corporate Law* (1991) 10. See ch 1 for further detail.

49 Mandelbaum, "Regulation of Takeovers With Particular Reference to New Zealand" (December 1991) Institute of Policy Studies Conference on Takeovers, 2.

VI: EFFICIENT RESOURCE ALLOCATION AS A BASIS FOR REGULATORY POLICY

Takeover activity improves the efficiency of resource allocation, and hence the productive use of society's scarce resources. Regulation which restricts or deters takeovers will decrease economic efficiency. Takeovers bring about improvements in four main ways: by reducing agency costs, improving managerial efficiency, enforcing the corporate contract, and improving allocative efficiency.

1. Reducing Agency Costs and Improving Managerial Efficiency

The central weakness of the public company arises out of the separation of ownership and control. When one person controls another's wealth, interests may diverge. Tradable ownership claims create fundamental conflicts of interest between the shareholders who bear the risk and those who manage the business. Managers are agents who do not receive all the rewards of success or the penalties of failure, hence their incentives are not properly aligned with those of the shareholders. Managers who own only a small equity interest in the company have an incentive to enrich themselves at the expense of the other shareholders. Examples include the diversion of corporate opportunities, theft of corporate property, consumption of excessive salaries and perquisites, less effort and diligence put into work, and a reduced willingness to take risks even when the returns are high.[50] In the context of takeovers, management might prevent a transfer of control which would otherwise create wealth for shareholders, purely in order to protect their own jobs.

This divergence of interests may be controlled by monitoring managerial performance. However, monitoring is expensive, and it is difficult to measure the quality of an employee's work. Furthermore, who monitors the monitors? Another way of controlling the conflict in the agency relationship is to bond the managers' performance to the company's performance. For example, remuneration packages may include bonuses for increased profits, and managers may be required to expose some of their own wealth to company performance through share ownership. However, the imperfections in bonding and monitoring mean there will still be a residual loss to shareholders arising out of the imperfect alignment of the interests of managers and shareholders in the agency relationship. Collectively, bonding costs, monitoring costs, and residual losses are known as agency costs.[51]

However, there are other market mechanisms which help to reduce agency costs. Managers face a potent market for information arising out of the efficiency of capital markets. Poor performance is reflected in lower security prices. To the extent that managers have to compete to attract funds in capital markets, they must

50 Risks which are specific to a particular company are irrelevant to shareholders who hold diversified portfolios.

51 Jensen & Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 J Fin Econ 305; Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J Pol Econ 288.

face the scrutiny of investors and be penalised by a higher cost of capital.

A fall in share price also sends a signal to the labour market. Managers may be penalised in the future with lower salaries and poorer job opportunities. Competition in product markets also disciplines managers through lost market share, and in the extreme, the insolvency of the company. Managers are inspired to perform well in order to retain the status and increased salary that results from a growing company, and to avoid losing their jobs if the business fails.

Finally, competition in the market for corporate control helps to reduce agency costs and induces managers to act in the interests of shareholders. The market price of the company's shares reflects the present value of expected cashflows generated from assets as deployed by incumbent management, including waste caused by excessive remuneration and perquisites, reduced effort, and the diversion of corporate assets. Takeovers threaten the jobs of existing management, as it is commonplace for large scale restructuring to occur following a takeover. Prospective bidders monitor the performance of managers by comparing the potential value of the assets with their value as currently used. A large difference reveals an opportunity for a competitor to challenge for the right to control the corporate resources, and increase the wealth that those assets are generating. Thus, bidders reduce agency costs by performing the role of monitors. This reduces the cost of oversight by investors as "the market for corporate control serves as a source of external control on the internal control system of the corporation."[52]

The corollary of this argument is that takeover activity provides an incentive to managers to ward off the threat of a takeover by striving for improved performance. The best defence is a high share price. Competition in the market for corporate control provides incentives to enhance the efficient utilisation of resources which leads to private gains for investors, and social gains for the economy.

2. Enforcing the Corporate Contract

A tender offer provides shareholders with an opportunity to challenge management when agency costs and inefficiency become too high. Voting is not an effective means of disciplining management because dispersed shareholders frequently lack the power and economic incentives to remove under-performing management. The cost of acquiring information would be disproportionate to the incremental gain accruing to their small shareholding. Furthermore, other shareholders could "free-ride" off their efforts. It is rational for shareholders not to invest in acquiring information, and be "rationally ignorant".[53]

52 Jensen & Ruback, "The Market for Corporate Control: The Scientific Evidence" (1983) 11 J Fin Econ 5.

53 Pound, "Shareholder Activism and Share Values: The Causes and Consequences of Countersolicitations Against Management Antitakeover Proposals" (1989) XXXII (2) J of Law and Economics 357.

However, shareholders dissatisfied with managerial performance can sell their shares to the bidder. This provides an efficient way to challenge existing management decisions and enforce the corporate contract. The takeover mechanism facilitates the true potential in voting rights attached to shares: the power to aggregate shares and effect control changes.

3. Improvements in Allocative Efficiency

Bidders commonly pay a premium of fifty per cent over market price, an extreme valuation of the target company's worth, because they can redeploy assets to more productive uses and earn greater returns, hence justifying paying a higher valuation. For example, this may be accomplished by synergies which result from a merger, or releasing untapped potential in the capital structure of the company such as excess cash retained or unused debt capacity.

The bidder may also sell the acquired assets to other companies. The fact that the market price of a target's assets exceeds the total value of its equity implies that there are willing buyers in the market who can derive greater value from those assets than the target management. This generates private gains for shareholders of the bidder and improvements for society. The allocative efficiency of the economy is improved through the better use of society's scarce resources.

4. Empirical Evidence on the Effects of Takeovers on Economic Efficiency

> Back in 1789 Benjamin Franklin claimed that nothing was certain in life but death and taxes. If Franklin were alive and paying taxes today he might add a third immutable constant to his list: shareholders gain from takeovers.[54]

The empirical evidence that target shareholders benefit from takeovers is overwhelming. Studies in the United States, Australia and New Zealand indicate that, on average, all shareholders in target companies make substantial gains from takeovers.[55] The premiums paid for shares actually acquired in a successful bid average up to fifty per cent above the pre-offer market price.[56] Even unacquired shares make substantial gains because share prices rise following announcement of the bid and continue to trade at a premium after the takeover.

Returns to shareholders in bidder firms have proved to be much smaller:[57]

> [T]he evidence on the rewards to bidding firms is mixed, but the weight of the evidence suggests zero returns are earned by successful bidding firms in mergers and statistically significant but small positive returns are realised by bidders in successful tender offers.

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54 Black & Grundfest, "Shareholder Gains from Takeovers and Restructurings Between 1981 and 1986 : $162 Billion is a Lot of Money" (1988) 1(1) J of Applied Corporate Finance 5.

55 Jensen & Ruback, supra at note 52; Dodd & Officer, "Takeovers: The Australian Evidence" in Centre for Independent Studies (ed), *Takeovers and Corporate Control: Towards a New Regulatory Environment* (1987) 129; Amery & Emanuel, "Takeover Announcements and Shareholder Returns: New Zealand Evidence" (1988) 1 Pacific Accounting Review 42.

56 Black, "Bidder Overpayment in Takeovers" (1989) 41 Stan L Rev 597, 601; Easterbrook & Fischel, supra at note 48, at 194.

57 Jensen & Ruback, supra at note 52; Easterbrook & Fischel, ibid, 195.

However, although these returns are small, because the gains to targets are significant, the evidence indicates that takeovers create wealth overall. The net gains increase the combined value of the target and acquirer by an average of seven per cent.[58] The willingness of bidders to pay such high premiums over market price to target shareholders, without systematically losing wealth themselves, confirms the view that takeovers create value and increase allocative efficiency.

5. Challenges to the Efficiency Arguments

(a) Recognition of target undervaluation

One challenge to the efficiency arguments is that the share price of the target prior to the takeover does not reflect the true worth of the company. Hence the premium paid by the bidder is not a genuine premium over the intrinsic value of the firm. There are two versions of this argument. The first is that bidders wait for temporary depressions in the share price, then take over a company. This is really an assertion that the sharemarket is inefficient, and there is a large amount of evidence to disprove that proposition.[59]

The Securities Commission suggested a more sophisticated version.[60] The Commission argued that the true worth of a company may diverge from the market valuation because the market only values shares on the basis of publicly available information.[61] Inside information may indicate that the true value of the company is greater than market price. Companies subject to takeover offers may be identified by bidders as worth more than their market price because of information not known to the public. The premium paid represents existing value not yet revealed to the market, rather than the potential for increasing value by altering the company. Bidders effectively act as arbitrageurs.

This argument can be criticised on four grounds. First, even if market prices do not reflect the true value of shares, where a takeover corrects mispricing it has performed a valuable economic function because prices act as signals for capital allocation. More accurate prices lead to better capital allocation. Secondly, if a bidder took advantage of mispricing, management could easily defeat the offer by disclosing the information. This would cause an upward revision in the share price. If the information is commercially sensitive, or the company would break a legal obligation by revealing it, management could still cause the value of the information to be reflected in the share price without revealing the information itself. For example, management could counsel shareholders not to sell on the grounds that

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58 Bradley, Desai & Kim, "Synergistic Gains from Corporate Acquisitions and their Division between the Stockholders of Target and Acquiring Firms" (1988) 21 J Fin Econ 3; Franks, Harris & Titman, "The Postmerger Share Price Performance of Acquiring Firms" (1991) 29 J Fin Econ 81.

59 Supra at note 15 and accompanying text.

60 Securities Commission, *Company Takeovers: Report to the Minister of Justice by the Securities Commission* (October 1988) Appendix H.

61 This is consistent with the semi-strong form of the efficient market hypothesis used throughout this article. See supra at note 11.

the value of the company is much higher and the share price will rise in the future. To reinforce this claim management could increase dividends, repurchase shares, or borrow money against the future increase in value. If the market is still not convinced, management could advance a competing bid for the company. If they truly believe that the company is worth more than the market price, and more than the price offered by the bidder, it would be profitable for management to purchase control of the company themselves. Thirdly, the process described by the Securities Commission amounts to insider trading, which is prohibited by Part I of the Securities Amendment Act 1988.

The fourth criticism of the target undervaluation theory is based on empirical evidence. If bidders acquire bargains before the market reflects the true value, the price rise caused by the bid should remain when a target defeats a takeover offer. The higher true value would be revealed by the fact that a bidder offered a premium over the current market valuation. Studies show that the price rise is permanent only when offers are successful, and otherwise the gains dissipate within two years.[62] The price falls only slowly to its pre-bid level because the takeover offer has identified the company as a potential target, and hence the price will reflect the potential for target shareholders to gain from another bid in the near future.

(b) Exploiting the future – myopic investment horizons

In addition, institutional investors may focus too closely on short term profits. This pressures management to produce short-term gains in order to keep the share price high, at the expense of long-term investment. It is argued that there are incentives to abandon research and development, expansion into new markets, building brand recognition, or any other innovation or investment which does not yield immediate gains. In the long term, the competitiveness of the economy is undermined. Hence, takeovers are said to exploit the very future of the nation.

This argument amounts to another assertion of market inefficiency. It means that the market must disproportionately undervalue a project which increases the company's wealth merely because expected gains are too far in the future. The evidence establishes that this claim is false. Companies that announce new investment expenditure experience increases in share price even though it depresses current earnings. In fact, studies show that companies which have become takeover targets tend to invest less than the industry average in research and development and other sources of long-term competitive advantage. Furthermore, on average, substantial cuts in investment do not occur after a takeover.[63]

62 Bradley, Desai & Kim, supra at note 58.

63 Baker & Wruck, "Organisational Changes and Value Creation in Leveraged Buyouts: The Case of O. M. Scott & Sons Company" (1989) 25 J Fin Econ 163; Shleifer & Vishny, supra at note 4, at 748.

(c) Disruption to operations

Another challenge to claims of improved efficiency is that takeovers cause disruption to economic activity because the new controllers tend to break business operations apart, sell assets, and shut down some operations. Furthermore, the process incurs huge transactions costs and merely generates fees for professional advisers. In essence, this claim concerns the efficiency of the takeover process in generating value. The evidence of gains to shareholders discussed above[64] indicates that the value created by takeovers outweighs the disruption and transaction costs involved in the transfer of control.

(d) Exploiting the bidder's shareholders (management hubris)

A further objection to arguments of improved efficiency is that the source of the takeover premium is a mere overpayment by the bidder's management at the expense of its shareholders. Management is motivated to pay a premium by a desire to increase their power, prestige, salary and perquisites which are all correlated to the size of the company.[65]

This argument is supported by the fact that many takeovers occur in an auction situation between competing bidders. The "winner's curse" is that victory was obtained by making an offer which exceeded the valuations of the other participants. Such an offer was likely to have been over-optimistic and resulted in the successful bidder paying too much. Thus, takeovers provide an opportunity for a wealth transfer from the bidder's shareholders to the target's shareholders.

While it is true that, with the benefit of hindsight, many acquisitions have been mistakes, the potential for poor returns is a risk inherent in any type of investment decision. Poor judgment, or judgment affected by self-interest, which results in overpayment is not confined to investment decisions made during an acquisition of another company. Company law has addressed this problem by placing duties of care and good faith on directors. Incompetent or under-performing managers of bidder companies could be removed, and will be penalised by lower remuneration in the labour market.

Furthermore, the market for corporate control automatically disciplines managers who systematically overpay in takeover contests. The share price of the bidder will fall and the bidder will become a takeover target. Incompetent or egotistical managers will forfeit control. In short, bad bidders make good targets.[66]

The evidence also refutes this argument. On average, the bidder's shareholders make small positive gains, and studies also show that aggressive or high growth firms do not perform any worse than average as acquirers.[67]

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64 See text supra at page 260.

65 Roll, "The Hubris Hypothesis of Corporate Takeovers " (1986) 59 J of Business 197; Black, supra at note 56.

66 Mitchell & Lehn, "Do Bad Bidders Become Good Targets?" (1990) J of Applied Corporate Finance Vol 3, No 2, 60.

67 Lang, Stulz & Walkling, "Managerial Performance, Tobin's Q, and the Gains from Successful Tender Offers" (1989) 24 J Fin Econ 137.

(e) Exploiting employees and debt holders

Another objection to the efficiency arguments is that the gains to shareholders from a takeover are generated at the expense of employees and debt holders. Employees are said to be exploited by the bidder once control has been acquired by forcing wage reductions, reducing the size of the workforce, abolishing redundancy pay, and cutting pension entitlements. It is argued that this represents a breach of trust and a wealth transfer from employees to shareholders. However, labour market studies demonstrate that wage cuts and the removal of pension assets following takeovers are of insignificant proportions, and could not justify the size of the premiums paid by bidders.[68] Similarly, redundancies which occur after a takeover are small in comparison to the average rate for the economy, and occur mostly at senior management level.[69]

Debt holders might suffer following a takeover if changes in the company increase the level of default risk and therefore reduce the value of the debt. However, debt holders can gain protection by contracting in advance, and in any event, studies on tradable debt demonstrate that the value of the debt, on average, does not fall.[70]

On balance, only a small fraction of the gains from takeovers can be attributed to wealth transfers at the expense of employees or debt holders, which means this is an unlikely motivation for takeovers.

(f) Exploiting the public (taxes and monopoly)

The final challenge to arguments of improved efficiency is that shareholder gains from takeovers are generated at the expense of consumers. It is argued that companies acquire market power by merging with competitors. This allows the new combined entity to raise prices and recover the takeover premium by exploiting consumers. Alternatively, takeovers could be motivated by opportunities to avoid taxation arising from a merger.

These concerns are insufficient to justify the regulation of takeovers. They should be addressed directly through legislation preventing the acquisition of market power by merger and the erosion of the tax base. Furthermore, the evidence does not support the validity of these arguments.[71]

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68 Brown & Medoff, "The Impact of Firm Acquisitions on Labour" in Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (1988) 9; Pontiff, Shleifer & Weisbach, "Excess Pension Fund Reversions After Takeovers" (1989), cited in Shleifer & Vishny, supra at note 4, at 749 n12.

69 Shleifer & Vishny, supra at note 4, at 747-748.

70 Jarrell, Brickley & Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980" (Winter 1988) 2(1) J Econ Perspectives, 49.

71 Auerbach & Reishus, "The Effects of Taxation on the Merger Decision" in Auerbach, supra at note 68, at 157; Eckbo, "Mergers and the Market Concentration Doctrine: Evidence from the Capital Market" (1985) 58 J of Business 325.

VII: AUCTIONING OF COMPANIES AS A BASIS FOR REGULATORY POLICY

Some forms of takeover regulation are justified on the basis that they promote an auction among competing bidders. This is said to increase allocative efficiency gains. The principal example is "pause and publicity" regulation. In fact, such regulation adversely effects economic efficiency and imposes greater costs than the benefits it produces.

1. Adverse Impact on Economic Efficiency

Pause and publicity regulation creates disincentives for bidders to research potential targets and thus ensure an active market for corporate control. Without an active market for corporate control, agency costs are higher. Hence, share prices across the entire market will be lowered, which harms shareholders.

Disincentives to takeover activity arise because a bidder expends time and money acquiring costly information in order to identify targets. By requiring notice of the offer and imposing delays on the bidder, pause and publicity regulation reduces the rewards of this costly research by signalling to other potential bidders that a profitable opportunity exists and giving those competitors time to organise a competing bid. If the law promotes an auction, the property rights in the initial bidder's research are undermined because subsequent bidders can make a competing bid at a lower cost. With lower sunk costs to recover, the subsequent bidders can offer a higher premium, and so have a greater chance of success. This discourages initial bidders, without whom there would have been no auction. Reduced takeover activity implies less monitoring of management, higher agency costs, and therefore, lower overall share prices.

However, Bebchuk and Gilson[72] have argued that an auction may produce benefits for shareholders which outweigh these costs. By encouraging competition among bidders for control of the company, an auction increases bid prices and extracts greater gains for the target shareholders.

It is also claimed that an auction further increases the allocative efficiency gains derived from takeovers. The price which a bidder is willing to offer for control of corporate assets reflects the value which the bidder places upon them. A bidder can justify a higher valuation only where resources can be employed more productively. Therefore, a higher bid necessarily implies expected improvements

72 The arguments summarised here are outlined in full in the following articles: Bebchuk, "The Case for Facilitating Competing Tender Offers" (1982) 95 Harv L Rev 1028; Bebchuk, "The Case for Facilitating Competing Tender Offers: A Reply and Extension" (1982) 35 Stan L Rev 23; Bebchuk, "The Case for Facilitating Competing Tender Offers: A Last (?) Reply" (1986) 2 J of Law, Economics and Organisation 253; Bebchuk, "Toward Undistorted Choice and Equal Treatment in Corporate Takeovers" (1985) 98 Harv L Rev 1693; Gilson, "Seeking Competitive Bids versus Pure Passivity in Tender Offer Defense" (1982) 35 Stan L Rev 51. For an opposing view see Easterbrook & Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harv L Rev 1161; Easterbrook & Fischel, "Auctions and Sunk Costs in Tender Offers" (1982) 35 Stan L Rev 1.

in productivity. In an auction, the corporate assets are not transferred to the first bidder who is willing to pay more than the market valuation of the company under its current management, but to the highest bidder. Thus, an auction implies that resources are allocated to the highest valuing and most productive user.

However, it should be noted that the allocative efficiency gains are not necessarily lost without an auction because there will always be the potential for further transfers to any higher valuing users at a subsequent time. Although this implies further transaction costs, the need for subsequent transfers is not always avoided under an auction model because the new controller will often divest substantial assets anyway.

Bebchuk and Gilson also propose two answers to the problem of reduced monitoring. First, they argue that the initial bidder's sunk costs are not that substantial, or that they can be recovered by holding blocks of shares which appreciate during the auction. Secondly, they point out that large target shareholders search for bidders, just as bidders search for targets. Allowing target shareholders to auction information which they have acquired may, on balance, promote monitoring, though it discourages initial bidders.

Ultimately, neither argument prevails at a theoretical level. Although target shareholders benefit from the increased premium if a takeover occurs, a diversified shareholder does not know which companies will become targets beforehand, and may prefer to reduce monitoring costs across his or her entire portfolio. However, empirical evidence suggests that an auction is not beneficial for shareholders. Studies of regulation which requires delay and disclosure of information indicate that overall share prices fall upon their adoption.[73] Evidence of the gains to bidder's shareholders also indicates that the market for corporate control is already sufficiently competitive. Abnormal returns to bidder's shareholders were only found to be slightly positive, implying that, on average, bidders pay target shareholders the highest premium possible in order to earn a normal rate of return from the transaction. Therefore, it seems likely that overall efficiency is best promoted without an auction.

2. The Single Owner Standard

Pause and publicity regulation is also advanced because it allows shareholders to behave as a single owner would when selling an asset (the "single owner standard"). It is argued that a voluntary asset sale by a single owner to a willing buyer in an arms length contract ensures a mutually beneficial transaction for the parties, while also producing a result which is socially optimal.

The argument considers how a single owner sells an asset. The single owner does not sell to the first available bidder, but waits for the best possible offer. The asset is also advertised to induce competition. However, shareholders are

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73 Pound, "The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence" (1987) XXX J of Law and Economics 353; Easterbrook & Fischel, supra at note 48, at 204-205.

dispersed and cannot communicate easily or costlessly. There are problems in co-ordinating them to act as a single owner. If single shareholders wait for a higher price, they may be left in the minority which do not sell. In this situation, the law must help to co-ordinate shareholders to act as a single seller.

There are two problems with this analysis. First, the analogy of the single owner is defective. There is a liquid market for shares which always permits resale. For the single owner of an asset, the process of negotiation and encouraging competition among buyers is a substitute for the liquid market. It ensures that the asset is not sold for less than its true worth. The market price for shares is already derived from an open and competitive process among many buyers and many sellers. A bid over market price necessarily implies that the seller is not receiving less than the true value for their shares:[74]

> Actual single owners of assets attempt to sell them for the highest prices, but efficiency requires only that assets move to higher-valuing users. That society allows single owners to decide when to sell – that is, to charge what the traffic will bear – is a prudential response to the inability of external decision makers to know just what transfers would be value increasing. This inability is not a problem here because stocks are financial assets whose values largely are reflected in market prices. Therefore, *any* transfer of corporate assets at a non trivial premium above the market price is efficient ex ante, in the same sense that any voluntary contract is efficient ex ante.

Secondly, there is potential for abuse by the target management. The target management is the obvious candidate to act as bargaining agent for shareholders. By resisting the initial bid and delaying the takeover, management provides an opportunity for competing bidders to appear and encourages a competitive auction for the firm. However, the target management also have an inherent conflict of interest. It is difficult to distinguish between resistance in order to induce a higher price, and resistance to prevent the takeover altogether. Although the Draft Code prohibits defensive tactics, in many cases these can be hard to distinguish from honest resistance.

3. Adequate Time and Information to Assess the Merits of the Bid

The final justification for pause and publicity regulation is to give target shareholders sufficient information and time to assess the bid. However, to the extent that new information is made public by disclosures under the Draft Code, this information is impounded into the market price of the shares in an instantaneous and unbiased manner. Hence, there seems little point in giving shareholders information and time to assess the bid, when they only need to note whether the price offered is above the market price as adjusted following the disclosures.

Where securities are offered by the bidder as consideration, the target shareholders can compare the market price of the securities offered with that of the target shares. The only instance when disclosure and delay might be justified is if the consideration offered is non-traded securities. In this situation there is no liquid

74 Schwartz, "The Fairness of Tender Offer Prices in Utilitarian Theory" (1988) XVII J Legal Studies 165.

market to provide an objective valuation of the consideration offered. However, the disclosure requirements in the Securities Act 1978 already regulate the provision of information upon the issue of new securities. An amendment which accommodates the provision of information where existing non-traded securities are offered as part of the consideration during a takeover would address this problem.

VIII: EQUITABLE TREATMENT OF SHAREHOLDERS AS A BASIS OF REGULATORY POLICY

Takeover regulation may be justified because it is possible to achieve a more equitable result for shareholders even if some efficiency gains are sacrificed. Examples include mandatory bid rules, and equal price and treatment provisions. However, merit-based regulation harms shareholders and the economy by reducing efficiency gains derived from takeover activity. Furthermore, a fair and equitable approach does not require a rule that insists on ex post equality in the corporate contract if the investors prefer to contract on a different basis.

1. A Fair and Equitable Approach

The meaning of "fair and equitable" is central in the debate over takeover regulation. A compromise between maximising economic efficiency and ensuring that investors are treated fairly is often justified on the basis that it inspires investor confidence and enhances the international image of New Zealand's security markets. This encourages participation by small investors and overseas fund managers. The cost of capital is reduced and the competitiveness of capital markets is improved.

Ensuring fair treatment of all shareholders and encouraging investor confidence are clearly worthwhile objectives. However, it is misleading to approach the issue of regulation as a linear choice between the equity or efficiency objectives. Equality of opportunity should be the focus.[75] The objectives are not mutually exclusive unless equality of outcomes is sought:[76]

> We should be pursuing equitable procedural treatment for investors ex ante (before the transaction), rather than equality of result ex post (after the transaction). In New Zealand, this has been expressed as a regulatory philosophy of disclosure. This must be distinguished from merit regulation which attempts to protect investors from the consequences of their own reasonably informed decisions. There is a danger that securities market regulation for all investors will be driven by investor reactions to individual cases of bad conduct, or bad news in the markets, such as a sharp drop in the sharemarket index, or the collapse of one or several firms. Naturally, those who have lost money in transactions will want to reopen them with the benefit of hindsight ....

75 This approach to general securities law reform was adopted in the Report of the Ministerial Working Group on Securities Law Reform, in Commerce Clearing House, *New Zealand Company Law and Practice* (1991) 60,757, 60,759-60,760.

76 Ibid, 60,760.

A securities market which encourages investor confidence and is perceived as fair should provide a regulatory and legal framework enabling participants to define the terms of the contracts which they enter in advance. Corporate contracts should then be enforced in a manner consistent with the ex ante intentions of the parties, regardless of the equality of the resulting distribution of wealth between participants. This applies equally to the takeover rules which investors wish to adopt.

2. Harm to Shareholders and the Economy

Merit-based regulation, such as equal price and mandatory bid rules, aims to prevent two types of perceived inequity in the bidding process, namely, two-tier offers and a premium for control being paid to large shareholders.

A "two-tier" offer is a bid for a certain percentage of all outstanding shares sufficient to acquire control, with a further offer for the remaining shares at a different price. Usually the two-tier offer is "front-end loaded", meaning that the first tier of the offer is at a higher price than the second. Even partial bids, in which the offer is at a single price for a stated percentage of the outstanding shares, are sometimes perceived to be two-tier offers because of the potential for the bidder to conduct a merger once control has been obtained and "squeeze out" the minority at a lower price than the original bid.

Two-tier bids pressure shareholders to accept the offer, thereby facilitating a rapid transfer of control. There is a rush to be part of the first tier of acceptances at the higher price, to avoid receiving the lower back-end price. It is argued that this is coercive because shareholders sell at a lower price than they would prefer, for fear of being squeezed out at an even lower price following the bid. However, evidence indicates that shareholders do not receive lower premiums when two-tier offers are permitted.[77]

There are also a number of justifications for a premium for control being paid to large shareholders. First, large blocks of shares provide a cheap and rapid means to transfer voting power and, in some cases, transfer control. There are lower transactions costs involved in the acquisition of several large blocks than purchasing from many small dispersed shareholders. This facilitates value creating takeovers which benefit all shareholders.

These advantages would be substantially reduced under a rule which required the sharing of the premium for control, because there is no longer an incentive to aggregate large blocks. This would make it more costly for bidders to make a takeover offer, reduce the total number of takeovers that occur, and hence there would be less monitoring through the market for corporate control. Ex ante, shareholders prefer a rule that maximises gains, even if that means unequal treatment ex post.

Furthermore, large blocks of shares are less liquid and therefore more risky to hold. Large shareholders promote more effective monitoring through the influence

77 Bradley, Desai & Kim, supra at note 58; Comment & Jarrell, "Two Tier and Negotiated Tender Offers: The Imprisonment of the Free Riding Shareholder" (1987) 19 J Fin Econ 283.

which they exert over management. This reduces agency costs and promotes improved managerial performance. The activities of the larger shareholders are beneficial to all shareholders.

Finally, it is a restriction on the shareholders' property rights to prevent individual negotiations at the best price the owner can obtain. Simply because other shareholders do not receive the same price per share does not imply any appropriation of value by one shareholder from another.

It is an empirical question as to whether the gains from monitoring across all shares outweigh the extra gain to minority shareholders from a shared premium when takeovers occur. Empirical evidence indicates that the presence of large shareholders is perceived as value increasing for all shareholders, even though large shareholders may receive larger rewards for their efforts in the event of a takeover.[78] Furthermore, studies demonstrate that share prices fall on the adoption of equal price rules.[79]

However, the Securities Commission has argued that a mandatory bid rule would eliminate acquisitions of control which are a pretext for exploitation of minority shareholders.[80] The takeover premium may be justified not by value creation, but by the potential for distributing assets to the controlling shareholder in breach of the corporate contract.[81] Put simply, this is theft, and it is already prohibited by company law. The question is whether the cost of deterring many takeovers, the vast majority of which create wealth for shareholders, outweighs the gain from protecting minority shareholders from looting.

The problem is properly resolved by improving the existing mechanisms for enforcing prohibitions against theft, fraud and other abuses, not by regulating takeovers. In New Zealand, it arises because of the current barriers to enforcement. The Report of the Ministerial Working Group on Securities Law Reform concluded:[82]

> The Group considered that, in the majority of cases which might have caused loss, there were remedies available for disadvantaged stakeholders. However, many of the remedies available were not pursued by aggrieved parties .... The review of the practices and transactions tended to confirm the Group's initial view that the key problems in our regulatory environment are existing obstacles to enforcement ....

These problems are being addressed in the Companies Bill 1990. In addition there may be scope for decreasing the cost problems by allowing contingency fee litigation.

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78 Shleifer & Vishny, "Large Shareholders and Corporate Control" (1986) 94 J Pol Econ 461; Holderness & Sheehan, "The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis" (1988) 20 J Fin Econ 317.

79 Pound, supra at note 73.

80 Supra at note 60, at chs 1-3.

81 Termed "distributive shifts" as defined at para 2.17 of the Securities Commission Report, ibid.

82 Supra at note 75, at 60,769.

3. The *Pari Passu* Principle

The Securities Commission has further sought to justify merit-based regulation on the ground that equitable treatment of the small investor requires that shareholders are treated equally ("the *pari passu* principle"). In the 1988 Securities Commission Report on takeovers, the Commission viewed the membership and constitution of a company as a contractual matter, central to which is the *pari passu* principle:[83]

> Much of the law and practice about corporate equity share capital is constructed on a simple idea. Contributors to the corporate funds who rank last in the sequence of claimants against the corporate assets should (subject to prior claims) share in the distributions by the company simultaneously and pro rata to their contributions. We refer to this as "the *pari passu* principle".

The fact that higher unit prices are paid for large blocks of shares than for small dispersed holdings,[84] was said to be evidence of a "widespread belief" that corporate contracts based on the *pari passu* principle are not being observed in practice.[85] The Commission concluded that the *pari passu* principle was an "excellent policy for beneficial law reform"[86] and that its reinforcement required the premium for control to be shared.

The Commission reasoned that share prices should equal the present value of those amounts available for present and future distribution. Thus, if the *pari passu* principle was implemented properly, there should not be a substantial difference[87] in the market price of shares whether held in small or large blocks. No premium for control should be reflected in the market price of a large holding as the benefits of control attach equally to all shares that rank *pari passu*.[88]

This effectively treats control as a corporate asset, hence something to which all shareholders have a claim.[89] If a premium were paid for the inherent capacity to exercise effective control, or at least facilitate the acquisition of control, the owner of a substantial holding would appropriate part of a corporate asset, in breach of the corporate contract based on the *pari passu* principle (a "distributive shift").

However, this argument incorrectly applies the *pari passu* principle. Although distributions in favour of controlling shareholders should be prohibited as breaches of the corporate contract, the *pari passu* principle applies to the relationship between the company and the shareholders, not between the shareholders inter se. It is not concerned with the pricing of shares in the secondary market. This depends on what a buyer at "arms length" is prepared to pay, not what he or she ought to pay

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83 Supra at note 60, at para 1.1.

84 The difference is known as the "premium for control".

85 Supra at note 60, at para 2.19.

86 Ibid, para 3.28.

87 Ibid, paras 1.7 and 2.21(a).

88 Ibid, para 10.1 - 10.2.

89 See Berle, *The Modern Corporation and Private Property* (1968); Berle, "Control in Corporate Law" (1958) 58 Colum L Rev 1212; Clark, *Corporate Law* (1986) 492.

in a normative sense. All sellers of an identical commodity do not necessarily receive the same price in the secondary market:[90]

> It does not follow that, because shares, all other things being equal, are presumed to rank pari passu vis-à-vis the company, they should all be the same price in the market place, unless this is justified by further normative reasoning which links the principle with the shareholders inter se *and* the secondary market.

IX: RECOMMENDED TAKEOVER REGULATION IN NEW ZEALAND

It is submitted that the justifications for regulatory intervention in the market for corporate control are very weak. A mandatory code would not only be sub-optimal on the policy grounds discussed in this article, but it would also deny shareholder choice and prevent the evolution of rules which are best adapted to the individual company. If investors wish to adopt provisions regulating the takeover of their company, they could choose to draft such regulations as part the corporate contract. An alternative to the proposed mandatory Draft Code would be for the Panel to promulgate an optional code. This would provide a model which companies could choose to adopt if they wish. Those companies that wish to gain the benefits of standardisation, namely lower contracting costs and clearer interpretation, could do so by adopting the standard model. They would also gain the benefits of access to the administration and enforcement facilities provided by the Panel. It is submitted that this policy would lead to the most efficient and competitive market for corporate control, and would promote the competitive advantage of corporate New Zealand.

90 Farrar, "Company Takeovers – A Critical Examination of the Securities Commission's Report" (1989) 13 NZULR 312, 316.