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## An Overview of Takeover Defenses and the Characteristics of the Economy

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**Abstract:**

**Purpose:** The present paper offers an overview of takeover defenses and an analysis of the way in which economic structures and characteristics may influence the presence of takeovers and takeover defenses.

**Design/Methodology/Approach:** A brief definition of takeovers and takeover defenses is presented, followed by a thorough analysis of the different types of takeover defenses, frustrating and defensive actions. Then, there is an analysis of the economic structures and characteristics that may influence the employment of takeovers and defenses as well as their in-between interaction.

**Findings:** In economies which have dispersed ownership structures, contestability and higher investment strategies more hostile takeovers tend to occur and consequently, takeover defenses, whereas economies in which ownership is more concentrated takeovers are not employed frequently.

**Practical Implications:** The present article aims to offer a clarification on the interaction between takeover defenses and characteristics of the economy. Also, the analysis indicates the importance of the regulatory framework regarding these issues, taking into consideration the differences in the structure of the economies.

**Originality/Value:** It provides the framework to develop potential regulation and policies regarding takeovers and takeover defenses in order to promote EU harmonization and global cooperation.

**Keywords:** Takeovers, takeover defenses, legal framework, economy structure, hostile takeovers, frustrating actions, defensive actions, market for corporate control, ownership structure, EU, Eurozone, Brexit, dispersed structure, concentrated structure, contestability, strong economy, weak economy, privatisation, investments.

**JEL Codes:** K10, K20, K22, K23.

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## 1. Introduction

According to European Union law, “a ‘takeover bid’ ...shall mean a public offer... made to the holders of the securities of a company to acquire all or some of those securities, whether mandatory or voluntary, which follows or has as its objective the acquisition of control of the offeree company in accordance with national law” (Takeover Directive, 2004).

Takeovers could be classified in two categories; friendly and hostile (Gorzala, 2010). The former involve takeovers that are performed with the approval of the target board of directors, as opposed to the latter where no such approval is obtained. As a result, hostile takeovers usually produce takeover defenses in order to hinder or obstruct completely the imminent takeover (Kraakman, 2009). Such takeover defenses could be further categorized in defensive and frustrating actions, depending on factors such as whether the target board is allowed to employ them or whether they affect the decision-making process of the shareholders (Ogowewo, 1997).

However, it is crucial to examine how the different economic characteristics and structures may influence the presence of takeovers and takeover defenses. Stronger economies with secure market environments that promote investments have more takeovers, in contrast to weaker economies where the macroeconomic indicators tend to hinder market development. Furthermore, there are certain factors, such as privatisations, which may lead to the increase of takeovers thus, promote the creation of an open market for corporate control.

## 2. Takeover Defenses: Frustrating and Defensive Actions

An initial categorization of hostile takeovers could be made on the basis of the target’s board of directors’ actions. Cases in which the target board decides to employ defenses in order to frustrate a takeover bid are considered as operating on the “non-neutrality rule”, whereas when the target board does not perform any obstructive action without having the prior consent of the shareholders of the target company are cases considered as advocating the “board neutrality rule” (Article 9, Takeover Directive 2004).

Taking into consideration the above distinction, a division in relation to post-bid takeover defenses could be made in defensive and frustrating actions (Kraakman *et al.*, 2009). Defensive actions are defenses that are used by the board of directors in order to provide influence over the shareholders on a takeover bid that is imminent or that has already been made (Takeovers Panel, 2013). It is important to mention that these acts are permitted by law and they do not materially corrupt the decision-making process of the shareholders.

On the other hand, frustrating actions result to the takeover obstruction and to the above material corruption or deprivation of target shareholders rights. Although in

general such acts are not permitted due to the ‘no frustration’ rule (Article 9 of Takeover Directive), the board of directors is permitted to employ them in cases where the target shareholders have given their approval for their use.

### **3. Frustrating Actions**

#### **3.1 Restructuring Defenses and Target Repurchases Framework**

“Restructuring Defenses” are corporate restructuring actions used in order to frustrate a takeover bid. It is required to obtain prior shareholder approval and they result in an alteration of the securities of the company. Therefore, they are also referred as ‘changes to the assets of the company’. Some defenses that fall within this category could be considered Crown Jewels Defense, Greenmail, Privatisation, Defensive Acquisition and Liquidation. (Johansson and Thortensson, 2008). They are briefly analysed below.

The “Crown Jewels Defense” is an action that involves the target company selling its important divisions and assets to a white knight or a third party in order to put the company in a position where the bidder is no longer attracted to make a takeover bid (Zarin and Yang, 2011). It may then purchase back from the friendly company its shares according to a price that has been agreed beforehand through sale and lease-back agreements or otherwise (Johansson and Thortensson, 2008).

Furthermore, “Greenmail” or target repurchase defense involves the bidder company selling the target company’s shares to the latter at a higher existing premium (Shah, 1996) and prohibiting the bidder from purchasing again for an agreed time period (Zarin and Yang, 2011).

Another corporate restructuring defense is “Privatisation” with which a public company is being converted into a private one (Tachmatzidi, 2017). As a result, the company is no longer being traded on the stock market (Johansson and Thortensson, 2008), the board of directors retaining their existing positions and the shareholders making a profit from the received premium. Also, directors are able to retain their positions and the shareholders make a profit from the premium received.

“Defensive Acquisition” and “Liquidation” are two defenses which involve reductions in borrowing and termination of company trading, respectively (Johansson and Thortensson, 2008). It should be mentioned that liquidation is used as a defense only in cases where the premium paid by the takeover bidder is lower than the liquidation premium.

#### **3.2 Litigation Framework**

The board of directors of the target company might, in cases where there is prior shareholder approval, employ tactical litigation, or otherwise obstructive, in order to

frustrate or obstruct a takeover offer (Underhill and Austmann, 2002). This type of defense could be used before, during or after the relevant takeover bid contest (Ogowewo, 2007) and may include different type of actions. For instance, legal injunctions, restraining orders and antitrust litigations could be used by the target company (Zarin and Yang, 2011). These actions may consequently, lead in disclosure of the strategic plan and negotiations performed between the bidder and the target company with the latter receiving a higher profit from the takeover offer and as a counter-offer terminating the litigation proceedings.

Tactical litigation has some disadvantages, mainly in relation to delays in court, compliance procedures as well as costs associated with such delays, and therefore, possible inefficacy on what concerns long-term investments (Zarin and Yang, 2011). However, due to the fact that tactical litigation defense results in maximization of shareholder profit and increase of takeover bid prices, is considered as a highly successful defense (Ogwewo, 2007).

#### **4. Defensive Actions**

Defensive actions include several frameworks, such as Defense Document Framework, Lobbying, Seeking Alternative Bids and Profit Forecasts. An explanation of these defenses follows.

A defensive action that could be taken by the board of directors is the issuance of a circular, which is defined as a “Defense Document”, and includes the board’s opinion on the takeover bid as well as the positive and negative consequences the takeover could result in, taking also into account the hostile bidder’s strategic plan. It is issued equally to all shareholders, pension scheme trustees, employees’ representatives and individuals with information rights (Stokka, 2013). Such action is used, for example, in the UK (Rule 25.1(a) of the UK Takeover Code).

A defense strategy which does not require prior shareholder approval is the board of directors “Lobbying” for an appeal through the notification of competition authorities (Shearman and Sterling LLP, 2015/16) for the possibility of unfair competition (Kraakman, 2009). The board of directors could also, use the “Seeking alternative bids framework”; the White Knight or the White Squire defenses. These actions involve the target board of directors seeking alternative friendly takeover bidders without requiring prior shareholder approval (Stokka, 2013).

In particular, with the White Knight defense, the friendly bidder makes a counter bid to the original hostile bidder with the purpose to out-bid it and prevent the unwanted hostile takeover (Johansson and Thortnsson, 2008), therefore acquiring the whole target company. It is important to notice that the above defense is considered to be highly effective for the target company to obstruct a hostile takeover (Tachmatzidi, 2018).

However, there are several risks associated with the White Knight defense, mainly with the difficulty of collaborating with a friendly bidder that is in fact trustworthy (Zarin and Yang, 2011). For instance, there is the danger of the hostile bidder purchasing the target company's shares after the friendly bidder has acquired it ('Lady Macbeth strategy').

The White Squire on the other hand, involves the acquisition from the target company of a substantial block of shares by the friendly bidder. Consequently, the latter is considered as having a significant position of power within the target company that could, also, lead to the obstruction of the hostile bid through voting procedures.

Additionally, the target board of directors could influence its shareholders with the issuance of "Profit Forecasts", which include accountants' reports that the forecast has been issued responsibly and according to the official guidelines and processes (for instance, UK Takeover Code, Rule 28.1(a)(i)(ii)). This defense usually results in influencing negatively the target company's shareholders in relation to an imminent takeover bid (Tachmatzidi, 2018). However, it is stated that regulation for this type of takeover defense is imperative, due to the risks associated with misleading statements and their possible wrongful influence on the decision-making process (Ogowewo, 2003).

## **5. Advantages and Disadvantages of Takeover Defenses**

Both advantages and disadvantages could be found with the usage of takeover defenses during hostile takeovers (Tachmatzidi, 2017). To begin with, takeover defenses, especially in weak economies, could result in creating a market for corporate control which is more beneficial, efficient and open (Ruling, 2012). They, also, benefit the target companies in cases of misinformation or misleading valuations of their shares, as they are required to publish relevant information, resulting to the possible increase of their share value.

According to the 'bargaining power hypothesis', takeover defenses could be used as negotiation mechanisms in order to increase the target's company value and put pressure on the hostile bidder to raise the premium offer (Ruling, 2012). If they were used as such negotiating tools, they could lead to auctions, which would also in turn increase the takeover bid premiums as perspective hostile bidders would compete on the takeover offer. Another advantage of takeover defenses is their disciplinary function on what concerns the board of directors of the target company, as it creates the incentive to increase the company value and the target shareholders' wealth.

On the other hand, takeover defenses could also produce some negative consequences. The target board of directors might lose their incentive to direct the company in the most effective manner, as they will employ the relevant defenses and maintain their company position (Ruling, 2012). Additionally, the takeover offer by the hostile bidder after the employment of takeover defenses might be smaller and not as

profitable for the target shareholders, due to the fact that in some cases the bidder offers a higher from the market price premium in order to pressure the shareholders into agreeing with the offer.

## **6. Presence of Takeovers in Relation to Economic Characteristics**

Differences that appear in countries' economic structures have led to formulate the argument that there is interplay of influence between the presence of takeovers and their defenses with the different economic structures (Tachmatzidi, 2019). These differences may include ownership structures, contestability, lack of privatisations or investments, or even an economic crisis that may have affected each country and economy in a different manner. For this reason, even though one of the main aims of the European Union is the elimination of barriers in trade and free capital movement, it has been considered challenging to create a harmonised European framework on what concerns regulations of takeovers (Mukwiri, 2008).

### **6.1 Ownership Structure: Dispersed vs. Concentrated**

The ownership structure of the market is another important factor influencing the presence of hostile takeovers and their respective defenses (Tachmatzidi, 2019). A dispersed ownership is defined as a structure where the market is mature in terms of equity liquidity. In such a market, takeovers and consequently, their defenses, are more frequently present, as companies have multiple investors and the board of directors try to safeguard their companies (Dinga, 2005).

Notwithstanding, studies have argued that within a dispersed ownership structure, the board of directors might not serve towards shareholder wealth maximization but instead promote their own interests, due to the fact that this ownership structure is not considered as monitoring the board of directors closely (Dinga, 2005). Nonetheless, corporate governance can place mechanisms to face this problem (Goergen, 2005).

On the other hand, a concentrated ownership is considered as a structure where the majority of the companies are state or family-owned. Most companies do not tend to have multiple investors; instead, shareholders have large blocks of shares that influence and control the company in a greater way than in a dispersed economic structure (Dinga, 2005). Due to the close relationship formed between the target shareholders and the target board of directors, the latter are impelled to govern the company efficiently or otherwise face the threat of a takeover bid (Kachaner, 2012).

As a result, the incentives of the board of directors are high for effective management and due to the lack of different investors, takeovers and takeover defenses are not viewed often in concentrated ownership structures (Gramatidis and Koromantzos, 2015).

## **6.2 Contestability**

Contestability is another important factor to examine when considering economies and the presence of hostile takeovers, as it creates an open market for corporate control (Ruling, 2012). Shareholder wealth maximization is one of the main priorities of the board of directors, although in some cases conflict may arise between shareholders and directors when the former consider a takeover offer more beneficial whereas the latter wanting to retain their board position. Furthermore, a contestable market has low barriers on what concerns entry and exit, finance equity is relied heavily upon and institutional investors have an important market seat.

In a contestable market, takeovers may have a disciplinary effect, due to the fact that the board of directors try to perform high-quality and efficient management of the company in order for a takeover not to occur and for them to keep their current posts. Thus, the company itself, the board and its shareholders benefit from the ‘threat’ of a hostile takeover and as a result, company wealth and share prices may increase through such an effective allocation of resources and governance.

On the contrary, a market which is not considered as contestable has a more concentrated ownership structure where, as mentioned above, most companies are state or family-owned (Tachmatzidi, 2019). In such a market, takeovers and their defenses occur less than in a contestable market. However, in cases where defenses are required to be used, the most competent and experienced to decide which defense to employ is the company’s board of directors. Therefore, even in a market with such characteristics, takeover defenses may act as a tool of discipline, as the target board aims to employ the defense that would have the best possible outcome for the company.

## **6.3 Factors for the Development of a Market for Corporate Control**

There are factors, such as privatizations, investments and regulation, which may lead towards the development of a market for corporate control, especially regarding economies that are under crisis, and will consequently lead to an economy with more takeovers and respective defenses (Tachmatzidi, 2019). Firstly, one factor considered is the privatisation of the public sector, i.e. the privatisation of state-owned companies. This may create a more contestable market, where more emphasis is placed on equity liquidity, more investments take place and directors are hired and dislodged with greater frequency thus, creating a more competitive market.

Another crucial factor that contributes to a market for corporate control is investments. With investments, the ownership structure becomes more diffused, there is higher investor participation in the market and therefore, more regulation is required. For instance, the existence of agency cost problems are more frequent in companies which operate in countries that have a more dispersed ownership model and for this reason require corporate governance procedures to be put into place (Gogineni *et al.*, 2013).

Consequently, the aforementioned regulation of companies and respective processes could slowly lead to an open corporate control market, in which more takeovers and takeover defenses will emerge.

## **7. Conclusions, Proposals, Recommendations**

In conclusion, this paper presents an analysis of the interaction between takeover defenses and characteristics of the economic structure. Takeovers, takeover defenses and their regulatory framework are important factors of the economic activity that may further advance or hinder economic development.

It could be suggested that takeover defenses are present in high contestable markets with dispersed ownership structures, whereas they are less present in premature, non-contestable markets in which concentrated ownerships are a basic economic characteristic. Also, in mature markets, because of the institutional investors presence and the reliance on finance equity, there are more opportunities for corporate control. On the contrary, economies that operate in a non-contestable market do not tend to have an open market for corporate control.

The comparative analysis indicated that in economies where takeover defenses occur regularly, there is, also, regulation regarding the natural consequence of the development of takeover defenses by the board of directors of the target company. In contrast, in case of economies that there is no occurrence of takeovers, the absence of a regulatory framework for the takeover defenses is less advanced. Though, in the latter-mentioned economies, regardless the weak presence of certain regulated frustrating defenses, there are possible lawful actions by the board of directors that could be considered as actions of takeover defenses.

Moreover, special consideration in takeovers and the relevant defenses should be given in case of significant events in the environment that may trigger major restructuring both in economies and companies' ownerships. For instance, the 2020 pandemic and the 2021 departure of the UK from the European Union (Brexit) are critical events for the economic activity worldwide. Since the markets are experiencing volatile pressures, regulation of takeovers should be carefully designed to allow "functional economic sustainability", which means healthy competition and restructure for the advancement of the society at large.

Future research suggestions include the regulation of takeovers and takeover defenses in EU in the light of harmonization efforts. Given the significant differences in the structure and characteristics between the EU, and even more crucial Eurozone, countries harmonized procedures appear crucial not only for EU's economic development but for its' sustainability and survival as well.

Further, the potential formulation of a common basic regulatory framework worldwide may promote companies' advancement and offer a better economic

environment for development. An intense cooperation between market representatives and lawmakers is strongly recommended in order to consider the best regulatory framework that would address takeovers, takeover defenses and their consequences in the economic development.

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