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**Mergers and Takeovers - Proposals for Reform**  
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## **Mergers and Takeovers - Proposals for Reform**

The hostile takeover of Cadbury by Kraft was a clear illustration of need for mergers and takeovers to be regulated in the public interest. The TUC believes that the best way to do this is through the establishment of a Mergers and Takeovers Commission that would operate at arm's length from Government and whose role would be to assess whether or not proposed takeovers were in the long-term interest of the target company. Alternatively, the remit and membership of the current Competition Commission could be adapted to encompass a wider role than its current focus on competition. In either scenario, an appropriate referral system would need to be developed.

### Mergers and takeovers - the case for change

Merger and acquisitions have a mixed record in terms of generating value. However, that does not mean that they are all bad – there can be strong economic and operational reasons why two companies merging together makes sense.

What does not make sense is the way that mergers and takeovers decisions are taken in the UK.

There are two key questions to be addressed in assessing how merger and takeover decisions should be made.

The first is what criteria should be considered in deciding whether a takeover should go ahead.

This is a complex issue and there are many different considerations that will be relevant, but the key issue is the likely impact of the takeover on the long-term productive capacity of the company. Will the company be more likely to thrive under the new ownership or not? While answering this will require looking at a variety of different aspects of the company's development, the basic concept is relatively simple.

The second question is who should decide whether or not the takeover should go ahead.

In the UK, we have the wrong people making the wrong decisions on the basis of the wrong considerations.

Other than in the minority of cases that raise competition issues, in the UK whether or not a takeover goes ahead depends on whether or not shareholders want to sell their shares. And they generally will, if they are offered a sufficiently high price for them. Much of the 'debate' among institutional shareholders around whether or not the Kraft takeover of Cadbury should go ahead centred on the share price offered for Cadbury by Kraft. Ironically, paying a higher price and therefore making it more likely that the deal will go ahead has the effect of pushing up the amount of debt the company will carry going forwards, which will have the effect of hampering its future prospects.

In the UK, other than in the minority of cases in which competition issues are considered by the Competition Commission, shareholders are the only group with the power to say yes or no to a takeover, although the board of directors may make a recommendation. The board's recommendation is also usually made on the basis of whether a sufficiently high enough price has been offered by the company, although it is much too easy for bidding companies to offer management massive payouts that effectively act as incentives for them to recommend the bid.

So, the shareholders are allowed to sell the company, but there is no requirement on them to consider the future of the company in making their decision. They are allowed to make a decision which has major implications for the company, its workers, its local community, its suppliers and all its stakeholders on the basis of their immediate self-interest. This cannot be right.

In other countries this would not happen. In 2005, the French Government, faced with the prospect of the takeover of Danone by PepsiCo, drafted a law protecting companies in 'strategic industries' from takeover. While the Takeover Directive 2006 included a provision to prevent 'frustrating action' on the part of management when faced with a hostile takeover bid, implementation of this provision was not compulsory, and a number of European countries, including the Netherlands and Germany, have opted out of this requirement. In the Netherlands, for example, companies can have anti-takeover measures incorporated into their articles of association.

However, there are other differences in corporate governance and share ownership structures that make takeovers, and especially hostile takeovers, a much rarer phenomenon in Continental Europe. The UK's dispersed share ownership structure makes companies much more vulnerable to takeovers than Continental European companies, which are often protected by share ownership structures such as more concentrated share ownership, cross shareholding between companies, the

existence of voting and non-voting shares and pyramid ownership structures where cash flow rights are differentiated from controller rights.

Employee representation on Supervisory boards and Works Councils also acts to ensure that considerations beyond massive payouts are considered by company management in their recommendations.

It is important to note that even in its own terms the UK system of mergers and takeovers does not work, making the case for reform even more urgent. The basic rationale behind the UK system of mergers and takeovers is that it facilitates the efficient use of capital and that it provides the ultimate discipline on company management. Both academic research and day to day experience belie these claims. On the efficient use of capital, academic research shows that mergers and takeovers frequently destroy value. In terms of shareholder returns, shareholders in the bidding company generally obtain lower returns as a result of takeovers.

As for providing a discipline on company management, Cadbury illustrates the fact that it is often not just poorly-performing companies that are takeover targets. Even if a company is performing well, it is vulnerable to being taken over by a larger company, simply because the latter is able to find or raise the funds to do so. In the UK, all directors are elected by shareholders on a rolling three-year basis (soon to change to election on an annual basis) and this already provides shareholders with a means of removing ineffective managers.

In recent months, UK companies have been vulnerable to overseas bids because the weak pound is making their share prices look relatively low to companies whose assets are held in other currencies, regardless of any other considerations.

The other major economy with a similar shareholder structure to the UK is the US. Here companies are frequently protected from takeovers by 'poison pill' mechanisms. So UK companies are uniquely vulnerable to takeover bids. However, the TUC does not believe that blocking mergers and takeovers per se, as with poison pill processes, is the way forward. The TUC believes that takeover proposals should be subject to a long-term company interest test to ensure that where mergers do go ahead they will not destroy value in the economy as a whole.

### Proposals for reform of mergers and takeovers in the UK

#### **Mergers and Takeovers Commission and a long-term company interest test**

It is essential that decisions on takeovers are not left solely to shareholders and that there is a regulatory overlay that ensures that mergers and takeovers operate in the long-term interest of the company concerned. This could be done by a Mergers and Takeovers Commission. Its role would be to determine whether or not a takeover bid is likely to enhance the target company's economic and productive

capacity in the long-term. It could be required to take account of stakeholder interests, such as those of workers, local communities and suppliers, in the context of this broader question. While this would not (and would not aim to) prevent all takeover activity, it would greatly reduce the phenomenon whereby companies are bought, saddled with debt, jobs are cut or moved overseas, suppliers are displaced and local communities destroyed in order to allow hedge funds and other short-term investors to make a quick buck at the expense of some of the UK's most successful and best-loved companies.

### **What would a Mergers and Takeovers Commission look like?**

- Independent of or at arm's length from Government
- Its sole focus would be to assess whether or not specific mergers and takeovers would be in the long-term interest of the company concerned
- It could either have decision-making power devolved to it or operate by making recommendations to the Secretary of State, with the understanding that these would only be overturned in exceptional circumstances.
- Appointments could be made through the Nolan process, on the basis of expertise and relevant experience.

### **Long-term company interest test**

A long-term company interest test should include the following:

- At the heart of the long-term company interest test is the concept of the whether the proposed bid would contribute to the long-term productive capacity of the company. Assessing this should include examining the following:
  - What is the overall rationale for the bid? Is there an economic case being made that builds on the productive capacity of the company or is it just financial engineering?
  - Projections with and without the merger in terms of
    - Financial indicators, including turnover, profitability and so on
    - Levels of debt and schedule for repayments
    - Levels of planned investment in Research and Development, training
    - Likely impact on employment
    - Likely impact on suppliers
    - Likely impact on local community, including issues such as the role of the company in the locality, impact on local skills levels and so on

### **Reformed Competition Commission**

Alternatively, the remit of the Competition Commission could be adapted to include consideration of long-term company interest, and its membership adapted

accordingly. The referral system for mergers and takeovers would also need to be reformed.

### **Reform of voting rights**

In addition, there are corporate governance reforms that would reduce the influence of hedge funds and other short-term share traders in mergers and takeovers. One option (which the TUC recommended in its response to the Walker Review) is for voting rights to be conditional upon a minimum ownership period. An alternative would be for voting rights per share to increase with length of ownership, which would be probably more complex to administer but would give short-term share owners lesser voting rights rather than none. This would be an important reform in its own right (see TUC Walker submission for more information), but would still leave decisions about mergers and takeovers in the hands of shareholders alone. In the Kraft-Cadbury takeover, some of the long-term shareholders such as Standard Life and Legal and General were clearly in favour of holding out for a higher offer from Kraft, but there was never any suggestion that they would not acquiesce once that higher price was reached. While it is possible that holding out for this higher price would have driven Kraft away, this is by no means clear, and restricting the decision to long-term shareholders could easily just have meant that Kraft paid a higher price for the Cadbury. One consequence of Kraft paying a higher price would have been Cadbury being even more saddled with debt than it will be under the terms of the existing deal. This highlights again the absurdity of merger and takeover decisions being made on the basis of share price, rather than on its likely impact on the productive capacity of the company.

### **Restrict merger and takeover decisions to those shareholders who own shares when the bid is launched**

The rationale behind this proposal is to prevent shareholders from buying shares specifically to make money from a merger or takeover after an interest has been indicated by the purchaser. This is a worthwhile aim, but one problem with implementing this proposal is that media speculation about potential takeovers often starts circulating some time before a formal interest has been declared. Again, it is not likely that this proposal would make much difference in terms of actual outcomes, given that the main difference between long and short-term shareholders usually appears to be the price at which they are willing to sell.

### **Addressing conflicts of interests of board members**

Company directors currently face major conflicts of interests in merger and takeover situations, frequently standing to gain millions of pounds from the sale of the companies they manage. It is essential that this addressed; there is no reason why managers should stand to gain directly from the takeover of the company

they work for, and the law should be changed to prohibit company directors and senior managers from receiving direct benefits from takeovers.

### **Information and consultation of workers**

The takeover code has been revised in the light of European requirements to require information on the bid to be circulated to employee representatives or, failing that, to the employees directly, and for the view of employee representatives on the impact of the bid on employment to be circulated to shareholders. However, it is clear from the case of Cadbury and others that these relatively new requirements are not working well in practice. It is essential that a review of these and other relevant requirements (ie, sections 188-192 of the Trade Union and Labour Relations (Consolidation) Act 1992 on collective redundancies and the Information and Consultation Regulations 2004) is carried out urgently to assess their operation in relation to mergers and takeovers.

The **Takeover Code** applies to listed companies and unlisted plcs, but not to solely-owned private companies. This also needs to be addressed.

### **Extend protection of the TUPE Regulations to takeovers through share transfer**

The TUPE Regulations protect workers' rights where an undertaking is transferred from one employer to another (eg, in an outsourcing situation). If TUPE applies, it requires:

- information and consultation of the employees' representatives;
- that the terms and conditions of employment are transferred to the new employer with no variation;
- that any dismissals due solely to the transfer will automatically be unfair.

TUPE does not apply to takeovers that take place through a transfer of shares, including private equity buyouts. This leaves UK workers particularly vulnerable in comparison with workers in continental Europe because takeovers by share transfer are so much more common here, and because workers' rights to information and consultation, for example through works councils, are much stronger in continental Europe.

There is a strong case for extending the protections of the TUPE Regulations to takeovers through share transfer. This would weed out bids that are based on plans to extract value from the company by cutting the workforce and squeezing terms and conditions from those where there is a genuine economic rationale for the bid.

### **Increase disclosure requirements during the takeover process**

The Takeover Code already requires the bidding company to make a range of information about its plans available to shareholders, including the likely impact on employment. Company management is required to give its view on the bidding company's proposals. However, these requirements cannot and do not ensure that shareholders make their decision on whether or not to sell their shares on the basis of this information and it is far from clear that it has much impact on the decision making process at all. There is no basis for assuming that further information disclosures will have any impact on the outcome of merger and takeover bids if the decisions are left in the hands of shareholders. Introduction of the long-term company interest test into merger and takeover decisions could lead to increased disclosure requirements, but if they are not part of a wider reform package increased disclosure is very unlikely to have any impact whatsoever.

### Conclusion

While there are various corporate governance reforms that would improve the process around mergers and takeovers, if mergers and takeovers are to be regulated effectively in a way that protects companies' long-term value, it is essential that the decisions are taken out of the hands of shareholders and given to an independent Mergers and Takeovers Commission that would apply a long-term company interest test to proposed bids.