THE DAVID HUME INSTITUTE

VIVENDO·DISCIMUS

Papers prepared for the Inquiry into Corporate Takeovers in the United Kingdom

No 4

EVIDENCE FROM THE ASSOCIATION OF BRITISH INSURERS, THE ASSOCIATION OF INVESTMENT TRUST COMPANIES, THE OFFICE OF FAIR TRADING, THE DEPARTMENT OF TRADE AND INDUSTRY AND THE TRADES UNION CONGRESS

Hume Occasional Paper No.18

INQUIRY INTO CORPORATE TAKEOVERS IN THE UNITED KINGDOM

STEERING COMMITTEE

Mr Graham Bannock	Research Director
Sir Donald Barron	
Sir Adrian Cadbury	
Mr. Jonathan Charkham	
Professor Richard Dale	
Professor Robert Jack	
Mr. Jeffrey Knight	
Professor Sir Alan Peacock	Chairman
Professor Jack Shaw	
Mr. H. L. Snaith	Secretary

INQUIRY
INTO CORPORATE TAKEOVERS
IN THE UNITED KINGDOM

EVIDENCE FROM THE ASSOCIATION OF BRITISH INSURERS, THE ASSOCIATION OF INVESTMENT TRUST COMPANIES, THE OFFICE OF FAIR TRADING, THE DEPARTMENT OF TRADE AND INDUSTRY AND THE TRADES UNION CONGRESS

THE DAVID HUME INSTITUTE

1990

INQUIRY INTO CORPORATE TAKEOVERS IN THE UNITED KINGDOM

The David Hume Institute has been commissioned by The Joseph Rowntree Memorial Trust to conduct an Inquiry into the issues raised by Corporate Takeovers in the U.K. This paper is the fourth of a series presenting the results of research undertaken in the course of the Inquiry, and also submissions of opinion received from individuals and organisations which are thought to be of wide general interest. The Institute hopes in this way to keep the public informed of work in progress. The Final Report will appear in the late Spring of 1991. The papers reproduced here are set in the date order in which they were received.

The Institute has no collective views on any public policy question and is not committed to the views of any of its authors.

Alan Peacock
Executive Director

The David Hume Institute,
21 George Square,
Edinburgh, EH8 9LD.

© The David Hume Institute 1990

ISBN 1 870482 13 1

Printed by Pace Print (Edinburgh) Ltd.

CONTENTS

1. The Association of British Insurers page 1

2. The Association of Investment Trust Companies page 9

3. The Office of Fair Trading page 17

4. The Department of Trade and Industry page 28

5. The Trades Union Congress page 40

THE ASSOCIATION OF BRITISH INSURERS

1 Introduction

The Association of British Insurers is the main trade association for UK insurance companies. In 1988 its member companies received a total of nearly £49 billion in premium income worldwide, amounting to over 90% of the world-wide business transacted by the whole UK insurance company market. Of this total, £22.2 billion related to UK life insurance business and £12.7 billion to UK general insurance (i.e. non-life) business. Figures produced by the Department of Trade and Industry for all UK insurance companies show that at the end of 1988 these companies held total net assets of £229.6 billion in respect of their UK funds (i.e. excluding funds held by overseas branches, subsidiaries and agencies). Within this broad total, the holdings of UK ordinary shares were worth £73.5 billion at market values. The great bulk of these UK equity holdings, amounting to £66.6 billion, were in respect of long-term (i.e. life insurance) funds which, owing to the nature of their liabilities, have a greater need than general insurance funds to invest in real assets (equities, property) with a longer term and a lower degree of liquidity than would be appropriate for general funds.

Long-term insurance funds are, after occupational pension funds, the second largest group of institutional investors in the UK, but pension funds, with their even longer term liabilities, are proportionately more important as UK equity investors: their equity holdings at end-1988 were valued at £115.5 billion.

Because of the success and popularity of unit-linked life assurance policies in recent years, UK life offices have also become substantial indirect holders of equities via in-house unit trusts. At the end of 1988 their authorised unit trust holdings were valued at £18.3 billion, but although the corresponding 1989 figures are likely to show a significant increase, adverse tax legislation in the 1990 Budget may well lead to a subsequent decline.

2. Corporate Takeovers: Activities of Insurance Companies as Investors

The great bulk of the insurance companies' holdings of UK equities are in the form of shares in quoted companies: at end-1988 these were valued at £72.9 billion, compared with about £650 million in unlisted shares. Therefore in what follows, the discussion will be concentrated on quoted equities, although it should be noted that many of the points made will also apply to unquoted shares.

Broadly speaking, the ABI strongly supports the concept of a free market in corporate control, as it currently operates in the UK. Among the advantages of the present system are that:-

(i) The existence of a free market in corporate control acts as a discipline to ensure that company managements are kept on their toes.

(ii) Takeover prices are determined in the market place, taking into account the views of both existing shareholders and potential investors, rather than purely through secret negotiations between the respective companies' boards or managements.

(iii) There is a well-established regulatory structure which ensures the disclosure of relevant information to shareholders, and discourages insider dealing.

(iv) In particular, the Takeover Panel is a well-tried and tested organisation which can react quickly and flexibly to changing circumstances and new developments.

Insurance companies in the main regard themselves as responsible long-term investors, rather than in-and-out speculators, but they owe a duty to their policyholders and shareholders to assess each takeover bid for a company in which they hold shares on its individual merits. In doing so, there is a strong tendency to support the existing company management, but if a balanced assessment suggests that the price offered for the shares is unlikely to be surpassed within the foreseeable future were the company to remain independent, it would be difficult to sustain a position of refusing to accept the offer (other than in special circumstances, e.g. the possibility of a better offer appearing from another source). In practice, insurers very seldom sell to "raiders" in the market and are often among the last to accept a bid.

While the management of leading British companies is usually of high quality (see for example the results of a survey comparing the performance of the largest 250 companies in the whole of Europe, recently undertaken by management consultants P.E. International), in some companies it may on occasion become perceived that management performance is lagging. Insurers accept that the threat of hostile takeovers is a relatively blunt instrument for ensuring that company managers continue to perform satisfactorily. As an alternative, it has not infrequently been suggested that institutional investors should themselves more often become directly involved in shaking up slack managements. This indeed does happen more frequently than is apparent to the outside world - complete discretion is usually necessary for the success of these operations. Insurance companies (and other institutional investors) are prepared to devote the substantial amount of time and effort by senior investment managers needed to achieve a successful conclusion in a number of carefully selected cases each year, but obviously have not the resources to apply such treatment on a wide scale.

In cases where such action is decided upon, a single insurance company sometimes has a large enough holding to take the initiative, on its own or with one or two partners, in seeking management changes. In other cases, joint action may be taken by a group of the larger institutions concerned, which may comprise pension funds, unit trusts and/or investment trusts as well as insurance companies.

It should not be overlooked that, compared with successful hostile takeover bids, far more friendly takeovers and mergers are completed. The implications of these for the efficient functioning of the economic system in general and the capital market in particular may also be worth examining in the course of the Institute's study. It is, for example, often more difficult for shareholders and other outsiders to assess in advance the likely effects of such activities, and for analysts to determine in arrears the actual outcome in terms of improved performance or otherwise, than in the case of contested acquisitions.

Recently, a particular cause for concern has been the increased number and value of management buy-outs of listed companies, since in these the managements concerned are always likely to have better information about future prospects than shareholders. Recently, evidence has begun to accumulate from both sides of the Atlantic that while these buy-outs often achieve good financial results in the short-term (up to three years), these are often in effect achieved largely at the expense of employees, creditors, previous shareholders and the Revenue authorities, and that in the longer term the viability of these enterprises may be sapped by the heavy weight of debt incurred as a replacement for the pre-existing equity. In this context it should be noted that the ABI takes an active part in the Institutional Shareholders' Committee, whose representations have resulted in several changes to the Takeover Code to deal with problems arising from management buy-outs of listed companies.

3. International Considerations

The ABI and its members are broadly satisfied with the way in which the takeover system has operated in this country in relation to acquisitions of British companies by other UK-registered companies. However, they do have some concern regarding the way in which the system has operated in relation to the acquisition of UK companies by overseas predators.

This is not to criticise the concept of cross-border takeovers as such; indeed, UK insurers have over the years themselves made a number of acquisitions of insurance companies in overseas territories, usually on friendly terms but occasionally on a contested basis. However, over the past ten years or so evidence has emerged suggesting that the playing field for cross-border takeovers is far from level.

In the first place, many leading UK commercial, industrial and financial groups (including insurance companies) are quoted companies, with their stock market prices determined not merely by the strength of their own trading prospects, investment performance and balance sheets, but by the general earnings and dividend yield yardsticks deemed appropriate for the UK stock market as whole. Except in the USA and the Commonwealth, things tend to be rather different overseas, where typically there is less emphasis on the desirability of providing shareholders with a reasonable level of dividend income and less transparency regarding the presentation of company accounts. For example, in a number of countries the lack of published market values of investments makes it difficult to put an accurate valuation on the equity of any organisations, such as insurance companies, whose assets consist predominantly of financial securities.

It has been argued that one result of the relatively low valuation seen to be accorded to the shares of UK companies is to render them significantly more vulnerable to takeover than is the case for their Continental and Japanese rivals. Conversely, in these countries acquisitions by UK companies may be made more difficult and more expensive. Figures just published by Translinks European Deal Review in respect of 1989 transactions confirm this perception. They show that Continental European concerns took over 238 UK companies in deals worth some £14 billion, more than the combined value of all the other bids on the Continent. In addition, the figures show that there were very few successful hostile bids except in Britain. In the whole of the Continent, only three of the 64 quoted companies of which control changed hands in 1989 did so on other than friendly terms.

Although differences in accounting practices and shareholder attitudes may provide part of the explanation, another important reason why UK companies feel more threatened by foreign takeover than their counterparts overseas is that in most other countries there is a whole range of other obstacles to impede the successful completion of a hostile bid. A recent DTI consultation document on "Barriers to Takeovers" listed a comprehensive armoury of legislative, regulatory and institutional weapons used by some other EC countries to deter or prevent hostile foreign takeover bids, and few would deny that in Japan the obstacles are even greater.

Vulnerability to takeover is partly related to the relative size of the companies concerned. In this context it is important to note that, because over the whole post-war period the UK economy has grown at a substantially lower rate than those of its main competitors, the typical size of the leading UK companies in most industrial sectors is now smaller than that of many of their overseas counterparts. The UK contenders, therefore, although perhaps quite sizeable in terms of UK domestic market share, may be of much less significance when viewed in terms of international competition, and this is perhaps a point which should be taken more clearly into account when references of UK companies to the Monopolies and Mergers Commission are being considered.

To take the insurance industry as a particular case in point, as one of the relatively successful British performers against worldwide competition within its own field (as measured, for example, by its contribution to UK invisible exports), the change in the situation even within the past twenty years or so has been dramatic. Although in the 1970s the largest UK insurance companies were, in terms of size, important players in the world insurance scene, the more rapid growth of their main competitors' domestic insurance markets has meant that there are now many foreign insurance groups which are far larger than even the largest UK contender, the Prudential. Yet in terms of their relative success in promoting sales of insurance within their own home market, UK insurers can demonstrate a successful record. Figures published by the Swiss Re Insurance Company (in SIGMA) show that life insurance premiums as a percentage of gross domestic product/gross national product rose in the UK from 2.82% in 1980 to 5.25% in 1987, a level far in excess of that achieved by any other major industrial country except Japan (6.43%). In non-life insurance, premium volume growth was rather less, from 2.96% in 1980 to 3.10% in 1987. However, the latter level was still above those achieved by other major industrial countries apart from the USA and West Germany.

Taking account of all the points outlined above, we suggest that it is imperative that the UK Government should exert the utmost endeavour to persuade its EC partners to amend their legislation, regulations, accounting rules and other market practices in order to move more closely towards the UK system of handling corporate takeovers, in which decisions are essentially taken in the market place on the basis of the fullest possible information being provided to shareholders and potential investors. We believe that such a system would operate to the best advantage not only of UK companies and shareholders but to those of the European Community as a whole.

As a subsidiary point, we suggest that serious consideration should be given to the possibility of amending the terms of reference of the Monopolies and Mergers Commission so that they should take more specific account of competition within the EC market as a whole (and indeed of international competition generally), rather than merely within the UK. This issue will become the more pressing as progress towards achieving a Single European Market accelerates.

4. The Proposed scope of the Institute's Enquiry

One of the main factors underlying the development of the Single European Market is the realisation that if European enterprises continued to be confined largely within the bounds of their individual national markets, they would become increasingly dwarfed by the major competing companies based in the USA and Japan, with access to much larger home markets. As 1992 approaches, it is therefore not surprising that in many industrial and financial sectors company after company is taking steps to position itself for the Single European Market which will gradually be opened up. Accordingly, the pace of both domestic and cross-border joint ventures, co-operation agreements, mergers and takeovers has markedly accelerated within the last three years.

In the ABI view, this is an issue which should figure at the very centre of the Institute's study and we suggest that the research programme and the analysis should take full account of implications of the likely development over the next ten years or so of a fully integrated EC market. In particular, we suggest that any recommendations made should look sufficiently far ahead to take full account of the possibility that in, say, ten years' time the policy on the control of takeovers and mergers will be largely determined at a European level, with national Governments and other national institutions concerned merely with detailed implementation, and that only in respect of takeovers below a certain size.

THE ASSOCIATION OF INVESTMENT TRUST COMPANIES

The role of Investment Trust Companies (ITCs)

ITCs are joint stock companies incorporated with limited liability under the Companies Acts. They exist to provide a medium of collective investment whereby investors, small and large, personal and institutional, may participate in a flexible and diversified portfolio of equity securities under professional management. Some companies cater primarily for those who require a relatively high and growing income; some cater for those who are chiefly interested in long-term capital growth; the majority have both ends in view and try to maintain a balance between them. In the management of their portfolios, some companies pursue a policy of geographical specialisation and a few a policy of industrial specialisation, but the great majority maintain portfolios which are well-diversified both geographically and industrially.

In recent years, however, there has been a growth of specialisation in the investment trust sector. This includes the identification of a group of trusts known as "Venture Capital/ Unquoted Specialists" and the significance to the Inquiry of the activities of this group is discussed in more detail later in this memorandum.

ITCs assist the smooth functioning of the new issue market. Although ITCs have no flow of new funds, they participate in the underwriting of new issues and, as substantial users of the secondary market, contribute to the efficient operation of that market without which a viable primary market could not exist.

ITCs perform other functions of benefit to the capital markets and thus to the economy. These include the following:

(a) As investors seeking sustained growth rather than short-term capital profits, ITCs tend to act as a stabilising influence in the market; this is reinforced by the advantages derived from their closed-end structure.

(b) ITCs are concerned that the companies in which they are invested and their managements are kept under pressure to be efficient; they help to achieve this indirectly as users of the secondary market and more directly by taking action individually or collectively to improve management when the occasion warrants.

(c) As informed investors, ITC managements can be consulted either individually or collectively by the market or by individual companies on investment matters affecting the rights of holders of different classes of security, for example on a proposed re-organisation of a company's capital.

(d) Through their Association, ITCs are called upon by Government Departments and the regulatory authorities to give informed advice on questions affecting the operation of the securities market and are directly concerned in the operation of such bodies as the Panel on Take-overs and Mergers on which they are represented.

The role of ITCs in takeovers, both as investors and as victims, is discussed below, drawing attention to the particular aspects of efficiency and public interest.

Investment Trusts as investors

ITCs are strong supporters of private enterprise and a number of investment trusts invest a proportion of their assets in high risk or longer-term ventures where the rewards may take several years to appear. Apart from the large international general funds such as Foreign & Colonial and Globe which make such investments, and following upon the move to specialisation, there are two other particular groups of ITC which are now significant in this area, namely

(a) those which play a more active part in the economy; these trusts have been referred to as "merchant venturers" by a leading firm of stock brokers which specialises in the investment trust sector;

(b) those which provide finance for management buy-outs (MBOs).

"Merchant Venturers"

Examples of these so-called "merchant venturers" are;

(a) RIT Capital Partners, whose policy is "to make both listed and unlisted investments, mainly in the UK and USA. Our focus is on capital growth: quoted investments are mainly in special corporate situations and unquoted investments including development capital, leveraged buy-outs and special situation partnerships."

(b) Electra, with its emphasis on unlisted and new ventures. Its Corporate Statement is as follows:

"Our objective is to maximise capital appreciation while maintaining a level of dividends to shareholders which at least matches the rate of inflation. We use our substantial capital base to organise, structure and underwrite strategic investments both for our own account and that of other investors, institutional and industrial, generating fee income from this source. We use the financial community for banking syndication and other specialist financial services.

Our principal activity is the provision of equity finance for unlisted companies in the UK, on the Continent of Europe and in the USA. The specific areas on which we concentrate are leveraged and management buy-outs and buy-ins, recovery situations, investment in minority stakes in private companies, and financing and syndication of property and property-related transactions.

Our listed portfolio primarily consists of certain large listed holdings which originated from investments in private companies, and special situations where market anomalies can be exploited.

We have satellite or associated companies which operate in the specialist areas of leasing and trading aircraft assets, providing mezzanine property finance, corporate venturing and leisure".

(c) Govett Strategic, operating mainly in the listed field and whose investment policy is stated as "to achieve growth of capital and income through investment in selected world markets and to take substantial positions where the trust believes there is special value."

(d) Renaissance Holdings, an example of the smaller ITCs coming into prominence in this area, and whose policy is "to seek a balanced portfolio, of overall moderate risk, which includes rescue situations, relatively stable turnround projects, and 'special situations', where Renaissance, because of its speed of reaction or flexibility, is able to make investments into well managed growth businesses on its normal terms. Renaissance prefers to be the sole or the lead investor."

A further example, though being unlisted it does not qualify as an approved ITC, is 3i.

These "merchant venturers" have three identifiable spheres of operation:

(a) venture capital for new businesses, whether in the form of straight debt, direct equity or (more likely) a mixture of the two;

(b) development capital for growing unlisted businesses, again in the form of straight debt, direct equity or a mixture of the two;

(c) "vaseline" capital, to ease the restructuring of existing businesses. This covers a huge spectrum of widely differing opportunities, viz buy-ins and buy-outs; the

> regeneration and recapitalisation of sleepy or ill-financed listed businesses; the break-up of unwieldy conglomerates into their component parts, so that not only will the parts function better but also the value of their sum will be greater than that of the whole. The list of opportunities covers everything from Govett Strategic's involvement with Macarthys or DRG to RIT Capital Partners' involvement with BAT Industries and Globe's involvement in Isosceles.

The "merchant venturers" will not just provide capital for deals. They will help to make the deals themselves, through in-house opportunity-spotting, corporate finance expertise and (later) business planning advice. Such trusts are already playing a valuable role both in the restructuring of British industry at the macro level and in the financing of small emerging or developing businesses.

Management Buy-Outs (MBOs)

ITCs are ideal sources of finance for MBOs and their role in this area is well described in the article "Investment trusts: the MBO connection" by Michael Walton.

ITCs as victims of corporate activity

Corporate action has been a long-running theme in the investment trust industry. The underlying rationale is both simple and well rehearsed. As long as share prices of investment trusts generally trade at a discount to their underlying assets, they will offer opportunities for corporate action - whether it is basic discount stripping or more subtle variants, such as disguised rights issues.

While there is little new in this, corporate activity is undeniably a trend which ebbs and flows in the sector. The latest upswing in corporate activity developed in late 1987 and then persisted in 1988. During that year, over £1 bn was drained out of the £20 bn sector - although it should be added that a good proportion of that sum was accounted for by the bid from the British Coal Pension Funds for TR Industrial and General (TRIG), the largest general fund and the flagship of the Touche Remnant stable.

This can probably be attributed to a number of factors. In the wake of the stockmarket crash in 1987, trust discounts naturally widened, in turn enhancing the possible returns for those contemplating aggressive action. Stakes in a couple of Japanese trusts, for example, were built up when discounts had widened to over 30 per cent. However, as discounts narrowed significantly in 1989 the pace of corporate restructuring eased again.

The bid for TRIG in 1988 brought to a head a number of concerns to the investment trust industry and also a number of issues of significance to the structure of the savings market as a whole.

(a) The ever-declining influence of the private investor in the stockmarket and the corresponding increase in the holdings of institutional investors. A majority of the equity of many British companies is now controlled by 30 or fewer separate holders. Institutions enjoying a variety of fiscal privileges have forced the private investor to concentrate his assets in institutional hands. The best efforts of the present administration to increase the influence of private shareholders have not been matched by an increase in the scale of private holdings; individuals have actually been net disinvestors in company securities over the past decade.

(b) The incompatibility between the Government's stated commitment to encouraging wider share ownership and the fiscal privilege enjoyed by institutions.

(c) The wider implications of the concentration of fund management into the hands of fewer large players.

(d) The anti-competitive implications of the decline of the investment trust sector. While unit trusts for example offer similar opportunities, they do so at higher cost to the customer and they offer a less direct relationship with the equity market and inferior performance.

(e) The importance of the development of investment trust savings and investment schemes (ITSSs) which have attracted great support from private investors. The growth of these schemes is increasing the number of smaller shareholders, who tend to be loyal and so make the predator's task more difficult. In addition, this is a start towards fragmenting the power which is concentrated in the hands of the 30 largest fund managers.

(f) The fact that the ITCs which tend to come under attack are not those notably weaker in performance than average. In fact, such trusts have often produced above-average performance, not only by comparison with the trust sector as a whole but also by comparison with unit trusts (and even pension funds). The attacks are therefore not coming from substandard performance but rather from the fact that the corporate structure of an ITC is such that there tends usually to be a gap between share prices and net assets which attracts opportunistic attention simply because it is there. Pension fund and insurance company investors should be capable of taking a longer-term investment view and it is particularly objectionable when tax exempt institutions acquire stakes in trusts with the intention of liquidating or unitising them to improve their short-term performance. Trusts can therefore be picked off irrespective of size or performance record in order to satisfy the insatiable appetite of faceless institutions and opportunistic arbitrageurs for quick profits.

(g) The hint of "pass-the-parcel" among institutional holders of investment trusts arising out of a less than efficient market comprising only a few major players.

(h) Approximately one-third of the investment trust industry is managed from Scotland and a number of Scottish-managed trusts have been taken over or unitised. Although this trend has abated (as it has for the sector as a whole) further losses of investment trusts would weaken the Scottish financial services industry within which investment trusts play a major role.

EC Directive on Takeovers

The Association is a firm supporter of the non-statutory status of the UK's Takeover Panel.

THE OFFICE OF FAIR TRADING

Role of the Office of Fair Trading in the UK System of Merger Control

Introduction

1. Mergers policy in the UK is largely a part of competition policy. Like all competition policy, its object is therefore to strengthen the forces making for industrial and commercial efficiency and growth and to prevent conduct which blunts those forces. Exceptionally, as in the 1988 acquisition of shares by the Kuwait Investment Trust in British Petroleum, a reference to the Monopolies and Mergers Commission may be made to determine whether the merger is against the public interest for some reason other than detriments to competition.

2. Mergers which diminish competition are likely to be harmful. But at the same time mergers which do not do so have an important role to play as part of the competitive process by which resources are moved from less to more productive - and therefore profitable - uses.

3. The primary objectives of mergers policy are twofold:

a to identify and prevent mergers that reduce competition in the UK market;

b to allow other mergers to go ahead with the least possible delay or impediment.

4. This note is purely descriptive: it looks briefly at the historical background to mergers control in the UK, at the statutory framework and at government policy within that framework. The roles of the different bodies are then considered in a little more detail; then the paper looks at the analysis of competition made by the Office. Recent changes in procedures are reviewed. The paper is confined to the UK merger control system. It does not describe that recently adopted by the EEC, and which comes into force later this year.

Historical Background

5. There was no law in the UK to control mergers until 1965. Monopolies and restrictive trade practices (cartels) had been the subject of legislation in 1948 and 1956. After 1956, when the law was tightened up to tackle cartels, many of the companies that had been involved in restrictive agreements decided to merge, and the early 1960s saw a significant increase in merger activity. There was also a growing awareness that, if it was desirable for government to intervene in order to combat monopolies and restrictive practices, it was also desirable to prohibit mergers that were likely to create monopolies.

6. Merger control was therefore a logical and necessary corollary to the pre-existing controls over monopolies and cartels. The essence of the 1965 legislation is now to be found in the Fair Trading Act 1973. This is the principal merger control legislation in the UK, though reference is made below also to revisions introduced in the Companies Act 1989.

The Statutory Framework

7. The basic UK law gives distinct roles to the Director General of Fair Trading, to the Secretary of State for Trade and Industry, and to the Monopolies and Mergers Commission. The Director General advises, the Secretary of State decides, the MMC investigates. The Director General advises whether any qualifying merger should be referred to the MMC. He also advises the Secretary of State on action following the MMC's report on any matter that has been referred to it, in particular if there is an adverse finding .

8. The Secretary of State has the power to refer to the MMC for investigation any merger involving at least one enterprise operating in the UK where either the assets test or the market share test is met. Such a merger is called a "qualifying merger". The assets test is met if the gross (worldwide) assets acquired are over £30 million. The market share test is met where the

merger will create or enhance a 25% share of any market in the UK or in a "substantial part" of it. The market share test was originally set at one-third of the relevant market, but this was reduced to 25% in 1973. The assets criterion has been raised several times, largely to take account of inflation, but has been at £30 million since 1984. The law does not distinguish between contested mergers (ie "takeovers") and uncontested ones .

The Policy Framework

9. In law any qualifying merger can be referred to the MMC for investigation, but the Director General gives his advice on whether a particular merger should be referred within the parameters set by government policy. From time to time Ministers make statements about government policy towards mergers. For many years the policy has been to give prominence to competition as a criterion for reference, though other public interest issues have featured as grounds for referral from time to time.

10. In an important statement in July 1984, reaffirmed by subsequent Ministers, the then Secretary of State Mr Tebbit said that references would be made "primarily", though not exclusively, "on competition grounds". The statement was intended to increase the predictability of reference decisions by making it clear both that mergers would be referred if they appeared likely to reduce competition, and that reference on grounds other than competition would be extremely rare.

Some Figures

11. Mergers qualifying under the Fair Trading Act have in recent years represented between about a fifth and a third of all mergers and acquisitions by industrial and commercial companies recorded by the Central Statistical Office in its Business Bulletin Acquisitions and Mergers.

12. Only a small proportion of all qualifying mergers are

referred to the MMC. In the last ten years or so between 150 and 350 qualifying mergers have been examined by the Office of Fair Trading in each year, while the maximum number referred in any one year has been 14 (approaching 200 further merger proposals a year have been looked at but found not to qualify or to have been abandoned before a decision was reached). This represents about 5% of all qualifying mergers at the most, and thus about 1% of all mergers.

13. The number of qualifying mergers reached a peak in 1987 and has dropped slightly in the last two years. The value of the assets of target companies has risen sharply over the past decade, though obviously by rather less when account is taken of inflation (from an average of £13 million in 1979 to £96 million in 1989, or from £22 million to £77 million in 1985 prices).

14. The total value of the target assets in any year is always likely to be influenced by a small number of very large cases. For example, in 1989 eight cases where the values of target assets were £3,000 million or more were only 2.8% of the total number of qualifying cases considered, but accounted for 42.4% of the total value of all assets involved.

15. The largest proportions of the numbers of qualifying mergers in recent years have been in distribution, other business services, mechanical engineering, food, drink and tobacco, paper, printing and publishing, electrical engineering and banking and finance. There have been no clear trends apart from a fairly steady rise in the numbers of cases classified as 'other business services', which includes activities like accountancy, advertising, market research, rental and leasing.

The Different Roles

16. The distinction between the roles of the Director General, supported by the Office, the Secretary of State and the MMC is a feature of the UK system established since 1973.

17. The Office undertakes the task of reviewing the large number of qualifying merger situations that occur, focusing on their possible impact on competition. In deciding whether to recommend referral of a merger the Director General consults, through the Mergers Panel, representatives of all the government departments with knowledge of a case. Where he sees grounds for believing that the merger would create a significant degree of market power which might bring about a reduction in efficiency or exploitation of the consumer, the Director General will normally recommend referral to the MMC.

18. If the Secretary of State agrees that a more detailed scrutiny of the merger would be desirable, the MMC then has to look at the situation to determine whether loss to competition is as real as it appeared, whether it is likely to have damaging effects, and whether any other issues of concern from the public interest point of view arise. In doing this the MMC weighs up the possible detriments against the possible benefits to form a judgment of where the overall public interest lies. The MMC is required under section 84 of the Fair Trading Act to consider "all matters which appear to them in the particular circumstances to be relevant". The section mentions some specific factors which should be taken into account. These include the promotion of competition and of a "balanced distribution of industry and employment in the UK." The MMC also has to consider possible remedies.

19. The Secretary of State has powers to order companies to take steps to remedy the adverse effects of the merger which have been found by the MMC, but he can only exercise this power if the MMC finds that the merger is expected to operate against the public interest. He will invite the Director General to obtain a voluntary undertaking rather than make an order, wherever this will provide an effective remedy. The Director General has a role also at the implementation stage in advising the Secretary of State on the adequacy of undertakings given, and in monitoring their subsequent performance. The most

common remedy is that the merger is not allowed to proceed. Sometimes, however, adverse effects may be remedied adequately by allowing the merger to proceed, subject to conditions.

20. While the MMC has the power, and indeed duty, to take a wide view of the public interest, merger policy is not intended to act as a surrogate for regional policy or industrial and social policy. The wider the objectives of merger policy, the more ambiguous and unpredictable is the application of the policy likely to be. Other policy considerations (such as eg regional policy) are more likely to weigh in a decision not to intervene than in a decision to do so.

Establishing Jurisdiction

21. The vast majority of mergers which qualify for consideration by passing the assets test, have little or no impact on competition because there are no significant overlapping activities, because the combined market share is small, or because there are no vertical relationships which could affect competition.

22. When a merger does not meet the assets test, it is the market - share test which determines whether it qualifies for investigation: that is, whether an aggregate market share in excess of 25% is created as a result of the merger, or whether it already exceeds this figure and is further increased by the merger. It needs to be emphasised that the 25% market share criterion determines only whether a merger qualifies for reference (if the assets of the target company are less than £30m); it is not a statutory definition of market power and it is not the case (as is sometimes stated in reporting on mergers) that a 25% market share means automatic reference.

The Analysis of Competition

23. Once jurisdiction over a merger has been established, the task is to assess foreseeable effect on competition. This is a

matter of judgment, and is entirely distinct from that of establishing jurisdiction. A number of factors are taken into account by the Office in assessing the effect on competition of any structural change brought about by a merger.

a The larger the market share and the larger the increase in share as a result of the merger, the more carefully it is scrutinised.

b The strength of the other producers in the market including overseas competitors. Thus, bringing together two producers with 15% of the market each to compete with two already existing firms with 30% each is likely to be less damaging, or even positively pro-competitive, than creating a firm with a 30% market share in a diversified market with many small participants.

c The availability and cost of substitute products, and the degree of substitutability (where products are close substitutes they should be included in the market under examination, but there are often imperfect substitutes (eg taxis for buses)).

d The structure of the buyer's side of the market. Where there are large, powerful buyers, the risk of abuse of market power by the supplier is likely to be less than where the purchasers are numerous smaller firms or individual consumers.

e Barriers to market entry. There are many possible such barriers. For example, if an industry requires heavy investment, whether in fixed capital or in the development of specific skills and reputation, it is less easy to enter than one that requires little plant or where reputation is easily gained and training less specific. There may, therefore, be opportunities to exploit market power. Especially important as barriers to entry are any impediments which are faced by newcomers but not by the incumbent firms. An important example is exclusive dealing arrangements. If the distribution channels are all tied up by exclusive commitment to incumbent firms, entry into the market may be particularly difficult. In these circumstances the objection to a merger may be particularly strong.

National and International Aspects

24. Considerations of nationality are irrelevant to the competition analysis. Foreign-owned firms operating in the UK are treated in exactly the same way as British - owned ones, whether their role in the matter is that of bidder, target, competitor or customer. Likewise, imports to the UK enter into the computation of the relevant market shares in the same way as UK production does.

25. However, actual imports are not the only aspect of international competition. An important aspect of barriers to market entry is potential competition from imports. There are some markets (eg for many motor components) where the UK market is part of a barrier-free international market: sometimes this is a European market, sometimes wider still. In such cases, even when import penetration is now low, it may have the potential to rise rapidly. In these cases a merger which results in a high market share in the UK may nevertheless confer little or no market power.

26. Assessing the degree of openness of the relevant UK market to foreign competition is thus a central part of the analysis. It is important that such openness be genuine and not merely theoretical. This means that what is needed is more than the mere absence of formal trade barriers. Transport costs must be low, and there must be no commercial impediments to market entry from abroad. While the UK market is as fully open as this for many capital goods and industrial intermediates, it is less often so for finished consumer goods and services.

27. The competition analysis applied by the Office to mergers is thus international in its scope. This does not mean that the appraisal extends to the effect of a merger on competition outside the UK: but it does mean that, in the assessment of its effect within the UK, all suppliers and potential suppliers are considered, no matter what their nationality and no matter in what country they may be situated.

Regional and Local Aspects

28. Some mergers, although they are insignificant in national terms, may have an appreciable adverse effect on competition in a particular locality. The law requires that such local effects be considered in any "substantial part of the UK". That was the case with the Elders bid for Scottish & Newcastle which was referred to the MMC and considered by it. Some people argued that, since Courage and Scottish & Newcastle did not have tied estates in the same part of the country, and since neither had a dominant position, no investigation was needed. But the Office could not ignore the fact that the merger would have removed the ability of Courage to compete with Scottish & Newcastle in Scotland, where tied estates were less important and where their joint market share was 80%.

29. Bus services are inevitably provided at the local level. It is therefore necessary to consider the impact of mergers on competition in the local market. Three bus mergers have been referred to the MMC, involving services in Avon, Portsmouth and the Solent conurbation and Sheffield and surrounding districts. The latter two are still being examined by the Commission.

30. However, it needs to be emphasised that these are examples of cases where a competition objection was perceived in a local market. It is not current policy to refer solely because a merger might have some detrimental economic effects in a region eg the move of operations from one part of the country to another.

Merger Procedures

31. A number of changes in procedures have been instituted in recent years, designed to increase efficiency and flexibility in handling cases, and thereby to minimise delay in clearing mergers that do not appear to give rise to concern, and to accelerate the handling of cases that go to the MMC.

32. Two changes were introduced in the Companies Act 1989: a procedure for the voluntary pre-notification of mergers, and a power for the Secretary of State to accept undertakings instead of reference to the MMC. The aim of the new pre-notification procedure is to allow accelerated clearance of those mergers which clearly do not raise competition or other public interest concerns.

33. The legislation does not require parties to a merger to pre-notify. Where they choose to do so the Secretary of State will have 20 working days to give his decision. In certain circumstances the Secretary of State or the Director General can seek an extension to this period of either 10 or 15 working days. To enable the Director General to give his advice within a short period the parties must provide the Office with all the relevant information from the very beginning by means of a standard merger notice. Since the Office may wish to consult interested third parties the pre-notified merger must be in the public domain.

34. The Companies Act also brought in new provisions allowing the Secretary of State, on the Director General's advice, to accept enforceable undertakings to divest instead of referring a merger to the MMC. The main purpose of the new provisions is to avoid having to block a whole merger for the period of a reference when the merger gives rise to competition concerns or other public interest issues in only a part of the businesses being merged. The Director General will now be able to recommend to the Secretary of State that, instead of referring the merger to the MMC, he should accept an undertaking to divest that part of the business which gives rise to concern.

35. MMC investigations of referred mergers are now normally expected to take a little over three months rather than the six months that used to be required. This has been made possible by setting tighter deadlines for the submission of evidence, by more informal investigative methods and fewer meetings by the MMC, by changes in the pattern of work of Commissioners, and detailed changes in the handling of draft reports.

THE DEPARTMENT OF TRADE AND INDUSTRY

I. Introduction

1. The Department of Trade and Industry is pleased to contribute to this Inquiry. We understand that the Scottish Office is also assisting the Inquiry, and that they will be submitting a separate paper. We welcome the opportunity to put the Government's view - indeed, we encourage open debate on this subject - and shall be interested to see the conclusions of the Inquiry, as well as any of the other research papers produced.

2. In this Memorandum, we shall begin by setting out a general statement of the Government's approach and policy to mergers and takeovers. The Memorandum will then examine in more detail the legal basis to merger control in the UK; the Government's competition-based merger policy; arguments for other grounds for referring mergers to the MMC; and consideration of other relevant factors, such as the burgeoning European dimension to mergers and takeovers.

II General Statement

3. The Government takes the view that, in general, the market should be allowed to decide whether a merger should go ahead, since the free commercial decisions of private decision makers tend to result in the most desirable outcomes for the economy as whole. Competition in free markets leads to an efficient, productive and flexible economy, which both delivers to consumers the goods and services they require at the lowest possible prices, and forms the only lasting basis for secure employment. In short, competition is good for wealth creation.

4. This is not to suggest that the market's decisions are correct in every case. In fact, the bulk of the evidence on post-merger commercial performance suggests that the merged enterprise has often failed to live up to the claims of the

acquiring firm at the time of the merger. However, the threat of takeover does appear to have a salutary effect on the incumbent managements of public companies. Any government action which places obstacles in the way of takeovers weakens this discipline. We refer the Inquiry to Annex E of the Blue Paper on Mergers Policy for discussion of the evidence on post-merger commercial performance, and of the effects of threat of takeover.

5. So the Government should only intervene in those mergers in which the private interests and the public interests diverge - typically, where a merger has the potential to allow the abuse of the merged enterprise's market power. The Government does not believe that it would be consistent with this general approach to intervene more generally in mergers, for whatever reason. Nor would it be consistent to reverse the burden of proof and to require those proposing a merger to demonstrate that their proposal would be positively in the public interest. However, in such cases in which intervention is justified, the Government is resolute and vigorous in its use of the powers available.

6. It should also be pointed out that although they do attract the lion's share of attention, contested bids only constitute a tiny minority of takeovers and mergers. We suggest that the Inquiry's investigations should reflect the numbers of agreed and contested transactions. We refer the Inquiry to the various statistical series published by the Government's Central Statistical Office as an authoritative source of data on mergers and takeovers within the UK.

III The Legal Basis

7. The legal basis to the merger control system in the UK is the Fair Trading Act 1973. Certain procedural changes were introduced in the Companies Act 1989, following a comprehensive review of the merger control system completed in 1988 (the results of which were published in a DTI Blue

Paper entitled "Mergers Policy"). Some of these changes are detailed in paragraphs 17 and 18 below.

8. The Fair Trading Act sets out the process of reference and investigation which lies at the heart of the UK system, by which the Secretary of State for Trade and Industry is empowered to refer mergers to the Monopolies and Mergers Commission (MMC) for detailed investigation, following advice from the Director General of Fair Trading.

9. The MMC must establish whether a merger that has been so referred operates or may be expected to operate against the public interest. The Fair Trading Act, however, does not define the public interest exhaustively: the MMC must take into account "all matters which appear to them in the particular circumstances to be relevant" (S.84(1)). This section of the Act does, however, include a number of indicators to which the MMC shall have regard in considering if a merger operates or may be expected to operate against the public interest. The majority of these factors relate to the maintenance or promotion of competition.

IV Government Policy

10. Within this framework, the Government's policy on the reference of mergers to the MMC sets out the criteria against which a merger is evaluated for possible reference to the MMC. The Government's merger policy is also formulated in terms of the 'public interest'. Following the review of mergers policy referred to in paragraph 7 above, the Blue Paper set out the basic policy that had been followed for a number of years: that the main public interest issue to be considered when deciding whether to refer a merger to the MMC is the potential effect on competition in the UK. Virtually all merger references are made on competition grounds.

Competition as Primary Grounds for Reference

11. The presumption underlying this policy is that, in general, the decision on whether a merger should be allowed to proceed is best left to those whose money is at stake. It is not the role of Government or statutory agencies to second-guess commercial judgements. However, Government intervention is justified if there are grounds for believing that the interests of private decision-makers run counter to the public interest. The classic example of such a divergence is where a merger appears likely to confer excessive market power on the merged enterprise.

12. Each merger is evaluated on its merits within this framework. In this process, an important concept is that of the "relevant market". The "relevant market" in each case may vary greatly: for some products or services, the sources of supply are confined, perhaps to just one, local part of the UK. Other markets, however, are national, where, for whatever reason, imports or international sources play only a small part, and competition is largely between UK companies. In other markets, the international dimension - from Europe or further afield - comes fully into play, with a wider range of sources of supply. Thus the analysis takes into account issues such as competition from imports; barriers to entry for competitors; and the market share of the merged enterprise against those of competitors.

13. One important element is the examination of any competition overlap between enterprises falling under common material influence or control as a result of the merger, either in the private or public sector. When a state-owned enterprise is involved in a merger, for example, the Director General of Fair Trading will examine all the state-owned enterprises in the relevant market sector which are under the material influence or control of the same government. Even if two companies were competing vigorously, it would be unwise to expect that competition to continue to the point where one

company forced the other to the wall, just as it would be unrealistic to expect two subsidiaries to compete to the death. Therefore, we consider that the important question is who has ultimate control of the companies.

14. It is sometimes argued that the prospective gains from a merger should be given greater weight in considering whether it should be referred to the MMC. For instance, it may be claimed that a merger will create a company of sufficient size to compete on an international scale, and that, therefore, the international competitiveness of the merged enterprise should be balanced against a possible threat to competition. However, while arguments about the prospective gains to efficiency, and to international competitiveness, from a merger are considered in appropriate cases, the policy remains that where there is a threat to competition, a reference should be made. It is for the MMC, during their detailed investigation, to assess the likely damage to competition and any likely off-setting efficiency gains, in reaching a balanced overall verdict.

Other Grounds for Reference

15. There are, of course, a number of factors apart from competition that are often claimed to give grounds for government intervention in mergers. While the Fair Trading Act allows for references to be made on public interest grounds other than competition, the Government has made it clear that any such references would be made only in truly exceptional circumstances. The Government's general view is that none of the matters above is one where the public interest typically diverges from the interests of private sector decision-makers. It is, however, recognised that in exceptional cases, such a divergence may occur.

16. As such questions appear to be central to the Synopsis of the Inquiry, it may be useful to consider each of the categories in more detail:

(A) Regional or local effects

Competition policy is of course relevant to the maintenance of both regional and local competition. But beyond this, a merger might have particular immediate - and in the short term adverse - effects on local employment if part of the plan behind the merger is to rationalise or integrate previously independent centres of production. There may also be social and cultural effects on a community if such a rationalisation stemming from a merger results in the movement of the company's headquarters away from the local area. A rationalisation from a merger may also affect other businesses - for instance, by eroding the regional infrastructure necessary to support other industries in the area. However, it is possible that such rationalisation would have taken place regardless of the merger. In any case, Government intervention in à merger is no guarantee of future employment prospects: the prevention of a merger does not impose any obligation on the incumbent management to safeguard the status quo. These matters are for management, not Government, to decide. Moreover, the failure to allow a takeover to proceed could jeopardise employment opportunities if the defending company has been over-optimistic in its forecasts, only to find later that it was in serious financial difficulties that led to a number of redundancies that had not been forecast at the time of the takeover bid. The Government believes that to seize upon the potential adverse effects of a merger - or "the fear that multinationals of other countries are more ruthless in their hiring and firing policies and take less account of the effects of their actions on local incomes and employment" (3.4 of the Synopsis to the Inquiry) as a reason for preventing it from proceeding would drastically reduce the economy's flexibility and adaptability to change, which is an essential precondition for economic success in a world of rapidly changing markets. The Government believes that regional issues are best addressed by other regional policies, not by mergers policy.

(B) Foreign takeovers of UK companies

The Government's general attitude towards inward investment by foreigners in the UK economy is to welcome it, and broadly speaking this applies to inward investment by way of acquisition of existing companies as much as to direct inward investment. UK companies engage in a considerable quantity of overseas investment, including acquisitions of foreign companies, and it is in the interests of the UK economy that there should be as little official interference as possible in this two-way flow. Nevertheless, there are instances in which foreign ownership of a UK company may raise particular concerns, and in such cases, the power to make a reference to the MMC is available for use. One consideration that may be relevant - in exceptional circumstances - is the extent to which UK companies have reciprocal freedom to acquire companies based in the home country of the prospective acquirer. In general, however, it would send out the wrong signals to refer bids to the MMC on this basis and would weaken both national and Community arguments that other countries should lower their barriers (see paragraphs 24-27 below).

(C) Leveraged bids

In relation to leveraged bids, the Government remains sceptical as to whether there is a normal divergence between the interests of private decision-makers and the public interest. For instance, some highly leveraged bids are rejected by the shareholders. The market can and does make sensible judgements in rejecting those bids in which the risks of a high degree of leveraging seem too great. The market has been warned about the dangers of high leveraging with the recent collapse of Drexel.

However, there may be profitable opportunities arising from the leveraged takeover which follows with the breakup of the target company, and in such cases, there must be a presumption that the profit arising from the assets concerned is being put to more efficient and more profitable use than in the original target company, and a further presumption that this is to the benefit of the economy as a whole. That is why the Secretary of State will not normally regard high leveraging on its own as grounds for reference. However, he will continue to consider referring such bids when he believes that a high degree of leveraging, combined with other features of the bid, may pose dangers to the public interest. In addition, where the protection of depositors or policy holders is involved in bank and insurance bids, the Bank of England and the DTI have separate legal obligations.

(D) Research and development

It is sometimes claimed that a particular target company will maintain a high level of R & D spending if it retains its independence but if it is taken over, the acquiring company management will cut R & D spending in the interest of short-term profitability, and will neglect the long-term future both of the company that it has acquired and of the economy as a whole. While this may happen it is, again, equally possible that the existing management will make bad decisions, whether on R & D or on other investments. Either way, it is not normally for Government to adjudicate between the R & D plans of rival managements: that is a matter for the shareholders.

V Reformed Procedures

17. The basic framework of merger control in the UK (the Fair Trading Act) and the Government's mergers policy remain

unchanged. However, following the review of mergers policy in 1988 (see paragraphs 7 and 10 above), the Companies Act was passed in 1989, which made a number of improvements to the operation of the merger control system. These include:

- a voluntary system of prenotifying mergers to the Office of Fair Trading
- a system whereby the Director General of Fair Trading can accept statutory undertakings to divest part of the merged enterprise as an alternative to an MMC reference
- automatic prohibition of share acquisitions during an MMC investigation
- a system of charging for merger control
- provisions by which companies must disclose that they have knowingly built up more than a 3% stake in another company's equity
- provisions to make giving misleading information to the competition authorities a criminal offence.

18. At this stage, no further changes to the merger control system are planned. However, practical experience of handling mergers under the new arrangements, coupled with developments in the Community's own merger procedures, may necessitate further consideration of procedures.

VI Interaction of Statutory Merger Control Procedures and City Takeover Code

19. The Government has no responsibility for the voluntary arrangements of the Takeover Panel, known as the Takeover Code. However, for a public bid, the statutory system of merger control under the Fair Trading Act runs in parallel to the Takeover Code timetable. While the competition authorities will endeavour to announce a decision to meet the effective closing date of the Takeover Code where practicable, the Secretary of State is under no obligation to announce his decision on whether to refer a merger to the MMC by any

specific date. When a bid is referred to the MMC, a bid lapses under the Takeover Code. If the merger is subsequently cleared by the MMC, the bidder has three weeks from announcement of the clearance to announce that the bid is to be renewed.

VII European Dimension

20. There have been a number of developments in the Community that deserve attention, and which are detailed below: the EC Merger Control Regulation, the continuing negotiations on the Takeover Directive, and the progress that has been made on Barriers to Takeover in the EC.

(a) Merger Control Regulation

21. The EC Merger Control Regulation, was agreed at the Internal Market Council on 21 December 1989. The adoption of the Regulation provides a welcome clarification of the powers of the Community and of the Member States, and should provide business with greater certainty about which jurisdiction is to be exercised. Even more importantly, the Regulation sets up competition-based criteria as the main grounds for EC investigation, mirroring the UK's own policy. Some of the important details are given below.

22. The European Commission will normally have exclusive jurisdiction above the financial thresholds set up by the Regulation. This will mean that the Commission will have competence over between 30 to 40 of the larger EC mergers each year, around the same number that the Commission considers at present under Articles 85 and 86. Of this number, around a dozen are expected to be UK mergers. Member States will have a role in such mergers only when the Commission judges that a Member State is better placed to tackle the competition problems arising at the level of a local or distinct market; or when a merger affects a Member State's legitimate national interests, such as defence or public security, for instance. However, under the Regulation, the Commission can only intervene in mergers below the thresholds at the

specific request of a Member State, and then only to remedy the competition problems in that Member State.

23. Particularly welcome are the criteria for the assessment of mergers under the Regulation, which are strongly competition based. The UK pressed hard for this in the negotiations in the Regulation. Mergers which create or enhance a dominant position and which significantly impede competition must be prohibited. Technical and economic progress can be taken into account only so long as they do not pose a barrier to competition.

(b) Barriers to Takeover

24. However, an effective EC merger control regime would not by itself achieve the important objective of a fair single market for corporate control. While the UK has the most liberal and open capital markets in the EC, a recent study commissioned by the Department of Trade and Industry showed that UK companies seeking to make acquisitions in other EC states face a wide range of barriers not faced by foreign companies seeking to invest in the UK. Some have suggested that the way to "level the playing field" is to reduce the opportunities available for foreign firms to acquire UK companies. The Government believes that this would be a mistake and that the proper way to tackle the problem of discriminatory treatment is not to erect one's own barriers but to seek to reduce or to eliminate the barriers erected by other countries.

25. The Government believes that the development of free and open capital markets within the EC, which is critical to the creation of a single European market, requires the removal of these barriers to takeovers. In many parts of the Community, capital markets may well be suffering a loss of efficiency through the effects of these practices and in addition an important stimulus for vigorous management is lost. These losses will of course become ever more clear as businesses recognise the need to restructure to take advantage of the newly

integrating European market, but are unable to do so.

26. It is for this reason that the Government is strongly behind the Commission's efforts to tackle the artificial, often protectionist obstacles to growth by acquisition across frontiers. Some of the barriers are structural and reflect different business cultures, such as the strength of family and cross-shareholdings, for instance. The scope for tackling these barriers by legislative action is limited, but it may be appropriate for dealing with a number of technical and regulatory barriers which may assume greater importance as structural differences reduce over time.

27. In order to reduce these barriers, the new company law proposals under consideration must be strengthened (and it will be necessary to introduce some new proposals) and the existing Directives must be enforced. In this context, the Government welcomes the EC Commission's announcement that it is to bring forward a programme to reduce or eliminate barriers - as well as the Council's agreement to examine these proposals, taking into account the objective of completing the internal market in 1992.

VIII Conclusions

28. This Memorandum has outlined the legislation and policy relating to the control of mergers within the UK; and has detailed developments in the EC relating to the control of mergers within the Community, the interaction between the UK and EC merger control systems, and recent initiatives to remove barriers to takeovers in the EC. It has also taken the opportunity to restate the rationale behind the Government's general approach to this question, which is that competition must be paramount. When regulatory systems attempt to move away from this core concept, it is the consumers - and ultimately the industries themselves, together with the people who work in them - who suffer.

THE TRADES UNION CONGRESS

Trade unions have an interest in all aspects of takeover activity, both in the direct effect of takeovers on the workers concerned, and in their impact on industrial structure. Through the TUC, unions are consulted about mergers that have been referred to the Monopolies and Mergers Commission, though these of course represent only a tiny minority of proposed takeovers: in 1988, only 10 mergers were referred to the MMC, out of 276 that qualified for reference according to the MMC's tests of market share and assets, and out of a total number of acquisitions of 1224 in that year. The TUC has also been involved in co-ordinating trade union views on takeovers that were not referred to the MMC, for example the Hoylake bid for BAT industries.

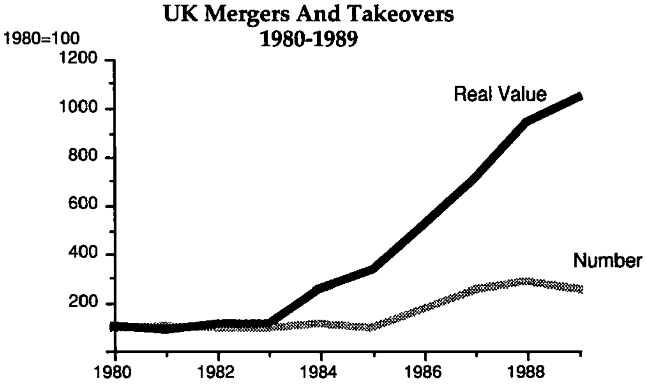
The TUC's submission to the Leisner review in 1986 set out the main principles of TUC policy on mergers and takeovers. In summary, the submission called for:

- a requirement on bidding companies to provide prior justification for their takeover plans;
- a wider definition of public interest, embracing international competitiveness, the interests of consumers, and the effects on employees, as well as the impact on competition;
- more effective monitoring of the claims and undertakings made by bidding companies;
- prior consultation and information for trade union representatives, including a fundamental recasting of the Transfer of Undertakings Regulations;
- measures to safeguard pension funds in the interest of their members.

These principles have been reiterated in subsequent Congress Resolutions, most recently a resolution in 1989, which also expressed concern about the way takeovers were financed, particularly those involving high levels of debt.

Recent Takeover Trends

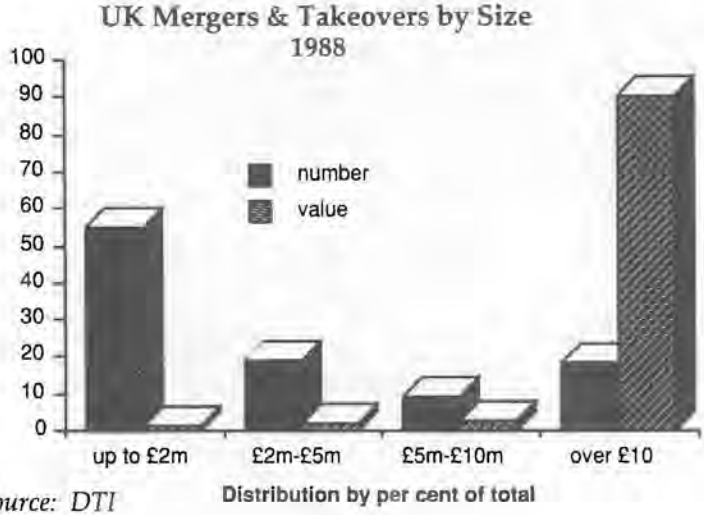
1989 was a record year for takeovers in the UK, 1039 acquisitions with a total value of £26.1 billion, a real increase in spending of 93% over the previous peak of 1972. Recent trends are shown in Figure 1.



Source: DTI

Figure 1

The current boom has seen increased activity at both ends of the size spectrum. 90% of spending on mergers in 1988 involved acquisitions of over £10 million, and transactions of over £250 million accounted for 55% of activity. These included very large acquisitions such as the £2.67 billion takeover of Rowntree by Nestle Holdings. On the other hand, thee was also a 82% increase in the number of acquisitions involving expenditure of £2 million or less between 1986 and 1988, when there were 678 takeovers with an average value of £700,000.

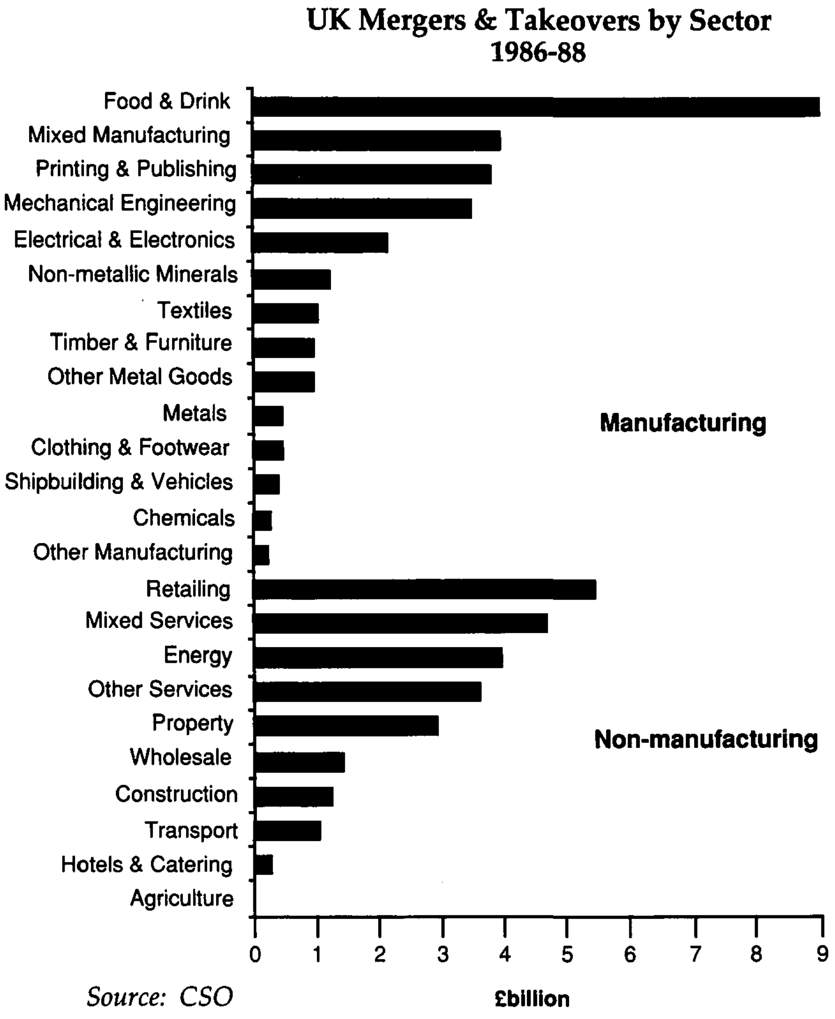


Source: DTI

Figure 2

The influence of a handful of very large takeovers has affected the pattern of takeover activity between industrial sectors, with the takeover of Rowntree, for example, bringing the food industry to the position of the largest manufacturing sector for takeovers in 1988. Nevertheless, recent years have seen a concentration of activity in food and drink, retailing, printing and publishing, mechanical and electrical engineering, and service activities including financial services. Between 1986 and 1989, just over half of spending on acquisitions took place within manufacturing, with the remainder in energy, construction and services.

Considerable concern has been expressed in recent years about the way takeover bids are financed, and the impact this has had on the subsequent performance of the merged company. This concern focuses on the use of high levels of debt to finance a bid, particularly in the form of junk bonds, or high risk, high return securities. This form of financing places pressure on the new management to repay the debt by short term returns to the detriment of long term performance. These concerns



Source: CSO

Figure 3

emerged as early s 1986 with the Elders IXL bid for Allied Lyons, and more recently the Hoylake bid for BAT Industries.

These forms of finance have not so far become a predominant part of UK takeover activity; the bulk of expenditure during the current boom has been financed by the issue of additional shares or, since 1988, by cash purchases. Indeed, one of the motivations for the boom has been the desire to utilise large accumulated assets without entering into real investment or tax exposure. In addition, the attraction of highly leveraged buy-outs has declined as both the short term profitability and the security of many firms has fallen. Nevertheless, the use of large amounts of debt in a number of key hostile takeovers remains a matter of concern.

In addition to concern about specific forms of finance for bids, the takeover boom raises questions about the financial pressures it places on firms. In particular, it reinforces the short-termism that is already evident in financial market. There is widespread concern in industry that share prices are determined primarily by their ratio to short term dividends, and tend to undervalue long term investment in research, product development and marketing. This means that the very fact that a company has devoted its efforts and its resources to building long term success can leave it vulnerable to takeover. Following a successful takeover, there is pressure on the new management to abandon long term research and investment, in order to increase the share price to repay investors. And even if a takeover is unsuccessful, or if a bid is only expected, there is pressure on the existing management to follow the same strategy in order to defend the company from takeover.

Opponents of this view claim that the threat of takeover creates pressure on managers to improve their performance. They argue that it creates a market for corporate control in which poor management can be replaced by a new and more dynamic team. A recent survey of academic research on the impact of mergers on the performance of companies (Alan Hughes in "Mergers and Mergers Policy" edited by Fairburn and Kay), however, questions whether there is any beneficial effect. Unlike earlier takeover booms of the 1950s and early 1960s, many recent mergers are not motivated by a clear industrial logic to bring together firms in similar or complementary industries in order to improve economies of scale, productivity or competitiveness. Rather, they take the form of incorporation into large conglomerates with diverse interests, and in which subsidiary companies frequently operate independently of others. Even where there is evidence that the profitability of the firm has increased after a takeover, it is questionable whether this is achieved by improved company performance, rather than by redistributing the company's existing resources to the detriment of employees, consumers and long term investment.

This is not to say that all takeovers are damaging or should be opposed. There are numerous examples where unions have supported a bid, either because it was intended to improve industrial competitiveness, or because it was the best way of protecting jobs. The recent Coats Viyella bid for Tootal, for example, which has subsequently been deferred, would have helped to secure an important part of the UK textile industry against international competition.

The TUC would not support an approach to regulation of mergers and takeovers which was either uniformly restrictive or uniformly permissive. Rather, what is needed is an effective regulatory mechanism which examines each bid on a case by case basis against a test of the wider public interest, taking account of the impact on industrial competitiveness, employment, and the consumer.

The UK Policy Framework

Since 1984, Government policy has been to refer takeover bids to the MMC "primarily on competition grounds". This means that bids will only be referred where they appear to restrict competition in a defined product market, and not on the grounds that they would damage the public interest in some other way. Nevertheless, the Government has chosen not to remove the flexibility that is available to it within the existing legislation to take account of other factors, such as the impact on international competitiveness, regional and employment considerations, the way a bid is financed, and the desirability of foreign ownership of particular firms. Indeed, the Tebbit doctrine of 1984 itself arose because of widespread uncertainty about the grounds on which bids were being referred at that time; between 1979 and 1984 it appeared that a decision on whether to refer a bid depended on the success of the parties concerned in lobbying Ministers, rather than on any identifiable criteria. Since 1984, the Government has used this flexibility in referring the Elders IXL bid for Allied Lyons partly on the grounds that it would be financed by large amounts of debt - although it has subsequently said that it will not normally regard high leveraging on its own as ground for a reference - and in the reference of the Kuwait Investment Office's 21% stake in British Petroleum on the grounds of the nationality of ownership. Moreover, once a bid has been referred, the MMC can take account of a wide range of factors, including the regional and employment impact of the bid, irrespective of the grounds on which the reference was made. The MMC has taken advantage of this flexibility, for example in its decision not to oppose the Monsanto bid for Rhone Poulenc in 1989.

Despite this flexibility, however, the Tebbit doctrine indicates a clear intention - recently reinforced by the Minister of State for Corporate Affairs - to restrict references to a strict competition criterion. What this means is not only that a decision to refer a bid will be examined against narrow criteria, but perhaps more importantly that conglomerate bids, which have been amongst the most prominent in the current boom, are effectively outside any regulatory control. These have included bids raising some of the most serious issues of public interest, such as the hostile bid by BTR for Pilkington which, though subsequently withdrawn, contrasted sharply the short term view of a diverse conglomerate against the longer term approach of an established industrial company with a record of research and investment. This has led Sir Gordon Borrie, the Director General of Fair Trading, to describe current powers and procedures as "benign and minimalist".

TUC Views

The 1980s takeover boom, and the Government's response to it, have led to a widespread feeling in all parts of industry that regulatory powers should take account of a definition of public interest that goes beyond the current narrow focus on competition. It is important to clarify what this would mean in practical terms; in most cases it would mean that takeover that did not restrict competition could nevertheless be blocked because it had other damaging effects. In some cases, however, it could also mean that a takeover that could restrict competition would be allowed to proceed, because there were other benefits, such as an improvement in international competitiveness, the protection of jobs, or benefits to the consumer, that would outweigh the loss of competition. Nevertheless, the overall effect of a wider definition of public interest would be that the regulatory framework would on balance be more restrictive than at present.

The TUC believes that, in assessing the impact of a proposed takeover on the public interest, the regulatory authorities should take account of whether a merger will:

- maintain and promote effective competition in so far as this is compatible with an international competitive capability and a positive balance of trade;
- promote the interests of consumers, purchasers and other users of goods and services, and environmental protection;
- encourage, through competition, a reduction in costs, development and use of new techniques and new products, and facilitate the entry of new competitors into existing markets;
- be in the interests of the employees of the firm, or firms;
- maintain production and output in the UK to the benefit of the economy; and

- secure national control of strategic industries, or be in the interests of national security.

Consultation and Information

As was pointed out above, only a handful of bids are currently referred to the MMC and even with the wider definition of public interest proposed by the TUC, it is inevitable that many takeovers will not be subject to regulatory control. This makes it all the more important that in all cases, whether they are referred or not, trade unions are able to represent the interest of their members effectively. In order to enable them to do this, it is important that trade unions in both the bidding and the target companies are consulted about all aspects of a takeover proposal which affects their members, and that they are provided with information on the intentions behind the bid. The TUC also believe that, rather than introduce such arrangements purely in times of crisis, they would be all the more effective if they were in place on a permanent basis.

The existing City Code and Takeover Panel, which operate on a voluntary basis, lay down certain minimal rules on the information to be included in the offer document by the bidding company, but this is of course only made available to shareholders and not to employees or their trade union representatives. Even if this information was extended to cover the impact on employment and future investment intentions, and made available to trade unions, the non-statutory basis of the Code and the Panel makes it impossible for them to monitor any undertakings to ensure that they are implemented. Consultation and information rights for trade unions would enable them to monitor undertakings on behalf of their members. But in addition, it is important that the regulatory authorities, having sought the company's intentions affecting the public interest, then monitor the implementation of these undertakings. In cases where undertakings are not implemented, the regulatory authorities should have the power to require the bidding company to divest its interest in the target.

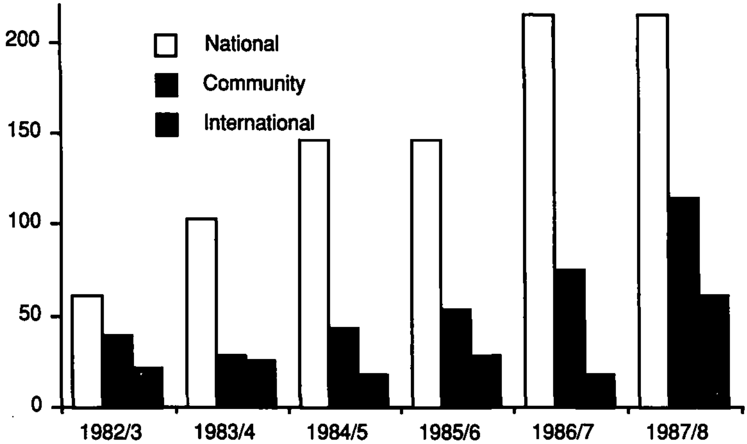
In order to allow them to examine mergers on the wider definition of public interest proposed by the TUC, and to allow them to monitor the subsequent implementation of undertakings, it is important that the resources of the Office of Fair Trading, and the Monopolies and Mergers Commission are expanded. The present system, in effect, requires the OFT to monitor takeover activity through press reports. The MMC currently employs only 109 full time staff, covering accountancy, legal, economic and industrial advice as well as the administration of particular references. In many cases, these staff have to deal with large numbers of specialist lawyers and lobbyists employed to represent the firms under investigation. Their number would therefore need to be expanded in line with the wider role envisaged for them by the TUC.

The European Dimension

The completion of the single European market in 1992 is widely expected to led to increased restructuring of European industry. Whether this arises as a direct result of Commission policies, or indirectly as a consequence of the psychological effect of the 1992 programme, or indeed as a continuation of existing trends in European industry, the impact is the same. Although mergers and takeovers are not the only forms this restructuring can take - a certain amount will take the form of expansion or contraction of existing firms, or of joint ventures and other cooperative arrangements - the pace of merger and takeover activity at the European level has already increased, and has given new impetus to the debate on EC regulation of such bids.

Main Trends in EC Mergers and Takeovers

The number of cross-border mergers and takeovers involving EC partners is relatively small compared with the number of national and international deals, but has increased substantially in recent years. Figure 4 shows the trends affecting the 1000 largest firms for the EC as a whole



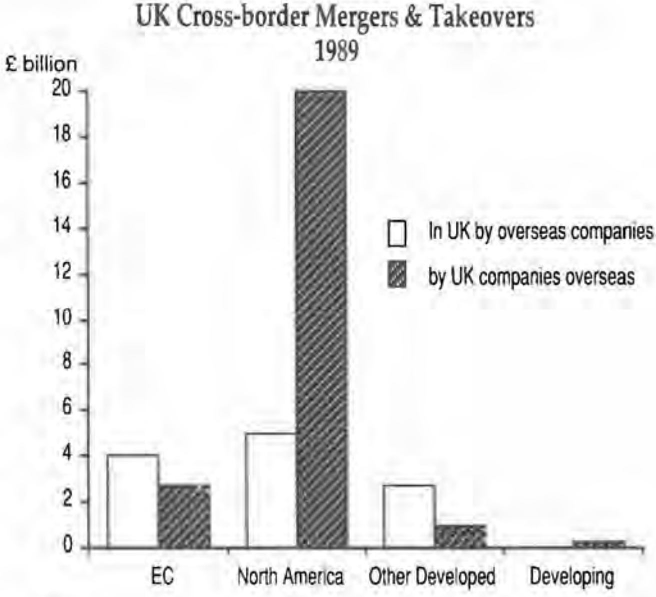
EC Cross-border Mergers & Takeovers
1982-88

Source: European Commission

Figure 4

The position of the UK within this total is influenced by the much greater importance of non-EC, particularly US, takeover activity, both inward and outward. The UK is an important acquiring nation within the EC, accounting for 21% of the total value of EC acquisitions in the first half of 1989, but is behind both France (27%) and the USA (23%). The USA remains a much more important target for UK acquisitions, representing more than seven times the level of the rest of the EC in 1989. As a target nation, the UK is in the leading position within the EC (39% of the EC total in the first half of 1989), but again this is dominated by takeovers by US firms, which account for roughly half of the total. The UK thus plays a major role in EC mergers and takeovers, though this is overshadowed by the greater importance of partners from the US, and other developed countries. Looking purely at deals within the EC, takeovers by UK firms in the rest of the Community totalled £2.56 billion in 1989, compared with acquisitions in the UK by other EC firms valued at £3.97 billion;

for the first time since 1986 EC firms spent more on acquiring companies in the UK than vice-versa (although in terms of numbers, there are still more UK takeovers in the EC than there are EC takeovers in the UK).



Source: DTI

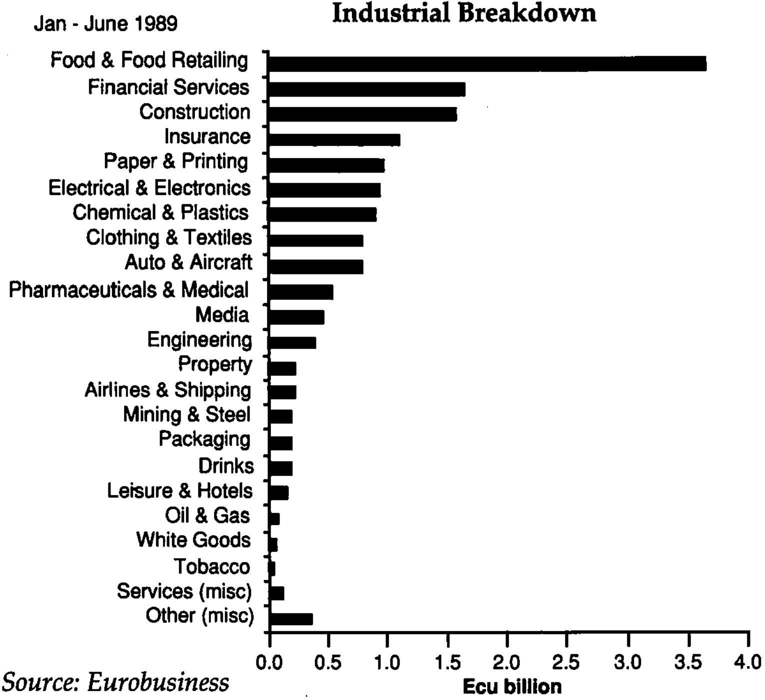
Figure 5

Reflecting the pattern at UK level, these trends in mergers and takeover activity are heavily influenced by a small number of very large deals; in the first half of 1989, for example, France became the leading cross-border acquiring nation within the EC, but 43% of its acquisitions were accounted for by a series of takeovers of Nabisco's European subsidiaries by the French food group BSN, worth a total of £1.2 billion. Firms with combined sales of over ECU1 billion (about £650m) were involved in 57% of all mergers in 1986-87, slightly more than in the previous year (53%). The share of the very largest firms within this total (ie combined sales of ECU 5 billion or about

£3.25 billion) increased from 10% to 22% in the same period. There has also been a rapid increase in the number of mergers and takeovers among smaller firms, whilst the share of those involving companies in the middle of the range has fallen. The importance of very large mergers - those involving combined sales of ECU 5 billion (£3.25 bn) or more - is a key issue in the debate on an EC merger regulation, as this is the current threshold for mergers that would fall within EC control.

As at UK level, the dominance of a few very large deals is also associated with the concentration of merger and takeover activity in a number of industrial sectors. Food and food retailing accounted for 23% of the value of cross-border activity in the first half of the year, and with a further three sectors - banking and financial services, construction and building materials, and insurance - the figure was brought to over 50%.

EC Cross-border Mergers & Takeovers
Industrial Breakdown



Source: Eurobusiness

Figure 6

It is widely recognised that the UK is a more open market for takeovers than the rest of the EC, and in 1988 three quarters of the value of EC takeovers were in Britain. This arises partly from short-term attitudes in financial institutions, and the fact that UK firms are more dependent on the issue of shares for corporate fiance than on bank lending. But it also arises from obstacles to takeovers in other countries. In West Germany, for example, large firms have a two-tier board structure which makes it more difficult for a bidder to take effective control of a company or to implement changes following a takeover. The involvement of unions in the supervisory boards of these companies helps to ensure that takeovers that would cut capacity and employment are unsuccessful. In addition, many West German firms issue non-voting shares, which do not give the purchasers of these shares power to change control of the company. There are also differences in the regulatory regimes in member states; France was singled out in a recent study by the consultants Coopers and Lybrand for the way its interventionist policies discriminate against foreign takeovers.

European Commission Proposals

Two separate EC Commission proposals have recently been under discussion; the merger regulation which will operate from September 1990 will give the Commission powers to vet certain proposed mergers in advance, and the draft directive on takeovers and other general bids would set minimum standards for the conduct of takeovers for public companies.

Merger Regulation

Current EC powers to control mergers are based on Articles 85 and 86 of the Treaty of Rome, which are intended to prevent anti-competitive behaviour or the abuse of market dominance. These Articles were not explicitly intended to form the basis for merger control, but a number of decisions of the European Court of Justice since 1972 have allowed them to be used to achieve that objective in certain cases. The effect is that in large scale mergers, companies feel they would be wise to inform the Commission, even though it has no formal regulatory powers, as well as their own national competition authorities. The Commission has been proposing a merger control regulation to formalise and clarify its powers since 1973, and this received new impetus in 1987 when UNICE, the European employers' federation, changed its view as a result of a ruling of the European Court of Justice (the Philip Morris/ Rothmans case) and began to express concern about the uncertainty and double jeopardy involved in the existing system. The Commission then threatened the extensive use of Article 85 to control mergers unless member states agreed to a new regulation.

The merger regulation specifies a threshold for EC control of ECU 5 billion (about £3.25 billion) for the worldwide turnover of the companies involved, and EC turnover for the smaller of the two companies of at least ECU 250 million (about £162 million). The British Government estimates that this will affect about a dozen UK mergers a year. In cases where more than two thirds of the total turnover was achieved in one member state, EC controls would not apply. The thresholds are significantly higher than the levels proposed in December 1988, when the Commission proposed that the main threshold should be ECU 1 billion (£650 million) and the exception level should be three quarters of sales in one member state. These changes were introduced by the Competition Commissioner Sir Leon Brittan in order to achieve a compromise, and would have the effect of reducing the number of mergers that would fall under EC control. The thresholds will be revised after 4 years on the basis of a qualified majority vote, when there could well be a further acrimonious debate between member states, with most favouring a significant reduction in the threshold and the UK (depending of course on the outcome of the next general election) holding out for a higher figure.

Following lengthy discussion of the criteria for assessing mergers, the Council of Ministers finally agreed that the primary consideration should be competition, though the French and Italian governments had argued that the regulation should take account of industrial policy objectives, and Spain, Portugal and Ireland argued for both regional and industrial policy considerations to be taken into account. In the event, although both the Council of Ministers and the Commission indicated that competition would be the primary criterion, the wording of the regulation appears to leave some scope for wider considerations to be taken into account, and this will need to be tested after the regulation comes into effect. It includes the following appraisal criteria:

(a) the need to preserve and develop effective competition within the Common Market in view of, among other things, the structure of all the markets concerned and the actual or potential competition from undertakings located either within or outside the Community;

(b) the market position of the undertakings concerned and their economic and financial power, the opportunities available to suppliers and users, their access to supplies or markets, any legal or other barriers to entry, supply and demand trends for the relevant goods and services, the interests of the intermediate and ultimate consumers, and the development of technical and economic progress provided that it is to consumers' advantage and does not form an obstacle to competition."

Two other issues will need to be clarified when the regulation comes into effect. Firstly, whereas unions at UK level are formally consulted through the TUC when a merger is referred to the MMC, there is no formal mechanism with the European Commission. Unions can be and are consulted on an informal basis on the application of the European Commission's powers under Articles 85 and 86, but there is no provision in the merger regulation for systematic consultation. It is important that a formal procedure is established to ensure that both national trade union centres and the ETUC are consulted about all merger proposals investigated by the Commission.

Secondly, there remains some ambiguity about whether bids could be subject to double jeopardy. The Commission's objective throughout the negotiations on the regulation was to ensure that a merger should be subject to only one level of control, clearly determined by the threshold for the regulation. However, both the UK and West Germany resisted giving the Commission exclusive competence, and the the West German government in particular wanted to retain a right for the Federal Cartel Office to apply its own strict competition criterion where West German firms were involved. The final regulation takes some account of this concern. It allows for member states to re-examine mergers which have been passed by the Commission, but only in circumstances where the potential effect is confined to a limited geographic market, such as retailing, within a particular member state, and where a concentration threatens to create or strengthen a dominant position on a distinct market, be it a substantial part of the common market or not. In practice, the Commission expects cases where this happens to be rare, making this clause only a tiny exception to the "one-stop-shop" concept. Nevertheless, there is a question of how the decision is to be made; in effect the Commission officials who will decide whether member states should be able to re-examine a merger will be the same officials who will have decided the Commission's own attitude to that merger. The TUC believes that the circumstances in which member states should be allowed to apply their own criteria should be clarified.

Directive on Takeovers

The draft 13th directive on takeovers ad other general bids is concerned with the way bids are conducted, rather than the criteria on which mergers and acquisitions are to be judged. It would lay down the basic rules that member states should apply to the takeover process, which they could extend or strengthen in their own legislation, and would also require each member state to establish a regulatory authority to ensure compliance with the directive. The regulatory authority could be either statutory or voluntary, so that it would allow the UK's non-statutory Takeover Panel to continue to fulfil its present role. The main principles set down are:

- a maximum trigger point of 33 $\frac{1}{3}$% of a company's shares, above which a bid would have to be made; member states could set a trigger point below this level (so the UK's threshold of 29.9% would not be affected) but not a higher figure.
- above this level, a bid would have to be made for all of the target company's shares on the principle of equal treatment
- certain defences, which target companies can use to frustrate a bid or make it less likely to be accepted by existing shareholders, would be restricted
- there would be rules governing the timing of a bid and the nature of, and information to be included in, the offer document
- included in this would be a general provision for information for workers in the target company.

British Government attitude

Most of the provisions in the draft directive are similar to those in British legislation and the Takeover Panel's code. The provision of information for workers in the target company would, however, be a new addition to the code. The Government has, however, adopted a somewhat ambivalent attitude to the directive. Initially, the Government supported the drafting of a directive in order to create a level playing field for takeovers in the Community. The UK is acknowledged to be the most open market for bids in the EC; 80% of all takeover bids in the Community take place here, and such takeover activity as there is in other member states is concentrated in France and Ireland. Other than in these member states, contested bids are virtually unknown. Since the directive was drafted, however, the British Government has expressed concern that it would create binding rules that would restrict the flexibility of the current non-statutory system in the UK. This reflects the concern expressed by the Takeover Panel that, for example, the code of practice it currently applies on a voluntary basis would become open to legal challenge in the European Court of Justice. The Panel has also questioned whether a harmonised system throughout the EC is necessary, in view of the fact that there is relatively little takeover activity outside the UK, and the Government has said it may be preferable not to have a directive at all if it cannot accommodate the flexibility it is calling for. The DTI has issued a consultation document on these issues, and the Government has reserved its position on the directive.

Approach of other member states

Other member states have focused on the principles underlying the directive, rather than on its legal status. It is understood that France in particular wishes to see changes in the directive to allow a bid to be made for only two thirds of the target company' shares, rather than for all of the voting shares as in the current draft (and in current practice in the UK), and to allow defences by target companies to be retained.

The Commission has asked member states to reach agreement on the draft directive by June 1990. Although there is less political impetus than there is for the merger regulation, the takeover directive will be subject to a qualified majority vote in the Council of Ministers.

Trade Union Concerns

Trade union concerns on the directive focus on the employee consultation aspects. The current Commission proposal is for information only, and simply requires that the bid document and, in the case of unlisted companies, an expert's report, should be communicated to workers' representatives, according to the practice in member states. It could therefore circumvent independent trade union channels in the UK's case. An ETUC working group, on which the TUC is represented, has drawn up proposals for rights of information and consultation for workers', representatives in both the bidding and the target companies. The main points are as follows:

- the bidding company should be obliged to inform and consult its workers' representatives on its plan for the target company and the implications for the existing workforce. In particular, the information should cover employment and industrial relations, and the company should be obliged to take account of the views of workers' representatives.
- the bid document provided to the target company, and thereby to its workers, should include information:
  - on the plans for the immediate future for each plant or establishment
  - on any expansions or closures planned
  - on guarantees, or their absence, concerning pensions and pension funds
  - on employment guarantees or their absence, by plant or establishment
  - on guarantees, or their absence, concerning terms and conditions of employment
- the target company should be obliged to consult its workers' representatives and to provide a statement on acquired rights for the workforce. The target company should be obliged to take account of the views of the workers' representatives.

Some of these proposals have been included in amendments to the draft directive submitted by the European Parliament but, whilst the Commission has accepted some of the amendments by the Parliament, it has rejected some of those concerning consultation and information for employees.

Transfer of Undertakings Regulations

A resolution of the TUC Congress in September 1989 which expressed concern at trends in takeovers called for new legislation to restrict takeover activities and, where they occurred, to give protection to employees. Minimum standards required would include information and consultation for staff and their trade unions; maintenance of recognition, representation and bargaining rights of unions; and maintenance of existing terms and conditions until agreement was reached to change them. The resolution called for the new legislation to replace the 'largely ineffectual' Transfer of Undertakings Regulations. Since the resolution was adopted the TUC has undertaken an examination of the effectiveness of the Transfer of Undertakings Regulations, and in particular, the potential effects of the House of Lords decision in Litster v. Forth Dry Dock and Engineering Limited.

The Transfer of Undertakings Regulations are intended to give effect to the EC Business Transfer Directive 1977. A major weakness of the Regulations is that they do not apply to takeovers where control of one company passes to another by means of acquisition of shares. The EC Takeovers Directive described above will fill this gap. The provisions in the Regulation which are of particular importance to the TUC are the automatic transfer of contracts of employment from the vendor of the company to the purchaser, and the provision that any dismissal related directly to the transfer will be automatically unfair. The primary interest of any dismissed worker is to secure compensation for either redundancy or unfair dismissal. If the transferor employer is insolvent then the worker has no remedy unless the claim is transferred to the new employer.

Regulation 5 states that the contracts of employment of all workers employed 'immediately before the transfer' will be automatically transferred to the purchaser. If, despite being dismissed, a worker could argue that he or she was employed at that time, then any claim for redundancy or unfair dismissal could be made against the purchaser. Essentially this was the result which the House of Lords reached in the Litster case. They based their decision on a judgement of the European Court of Justice which has determined that any employees dismissed before a transfer took place who were dismissed because of that transfer would be deemed to be employed at the moment of transfer. Thus employees who were never in fact employed by a purchaser would be entitled to their employment rights and the purchaser would be liable.

The TUC sees the Litster case as important and is conducting a review of the experience of affiliated organisations in making use of the regulations.

The Litster decision does confer additional protection on employees of an insolvent employer, but beyond that the implications of the case are unclear. Although the House of Lords has said that the Regulations must be read so as to give effect to the Directive this still leaves open questions relating to information, consultation and pension rights. While the implications of Litster appear generally favourable to trade unions, it is also the case that a decision of the House of Lords cannot tackle the fundamental weakness of the Regulations. With those considerations borne in mind the TUC would suggest that the existing Regulations could be used as a model for future national legislation to implement the draft Directive on takeovers, taking account also of industrial policy and public interest aspects.

Conclusion and Recommendations

The takeover boom is a reflection of the short-termism that pervades British industry. This is not to say that trade unions are always opposed to specific takeover proposals, and the TUC believes each bid should be examined on its merits. The Government's narrow focus on competition as the primary criterion for referring bids to the MMC is, however, inadequate and misplaced.

The TUC would like to see an effective regulatory framework, including:

- a requirement on bidding companies to provide prior justification for their takeover plans
- a wider definition of public interest, embracing international competitiveness, the interests of consumers, and the effects on employees, as well as the impact on competition
- more effective monitoring of the claims and undertakings made by bidding companies
- prior consultation and information for trade union representatives, including a fundamental recasting of the Transfer of Undertakings Regulations
- measures to safeguard pension funds in the interest of their members.

In view of the increasing importance of the European dimension in mergers and takeovers, the TUC would like these principles to be reflected in law and practice at the European level in the merger regulation and draft takeovers directive.

THE DAVID HUME INSTITUTE

HONORARY PRESIDENT (1988-1991)
Judge Thijmen Koopmans, Court of Justice of the European Communities

PAST HONORARY PRESIDENT (1984-1987)
Professor George Stigler, Nobel Laureate in Economics

HONORARY VICE-PRESIDENTS
Dr. Samuel Brittan
Professor James Buchanan, Nobel Laureate in Economics
Professor David Edward, CMG, QC.
Senator Professor Francesco Forte
Lord Grimond of Firth
Professor Neil MacCormick, FBA.

BOARD OF TRUSTEES
Professor Grant Baird
Mrs Catherine Blight
Mr Peter Clarke
Sir Gerald Elliot, FRSE, (Chairman)
Lady Mackenzie Stuart
Professor Sir Alan Peacock, FBA, FRSE.
Professor Jack Shaw

EXECUTIVE DIRECTOR: Professor Sir Alan Peacock

Personal Assistant: Kathryn Mountain

SECRETARY AND TREASURER: Mr. H. L. Snaith

SENIOR RESEARCH FELLOW: Mr Robert Pringle

ADVISORY COUNCIL

Professor Norman Barry	Buckingham
Professor Richard Dale	Southampton
Professor Bruno Frey	Zurich
Professor Brian Griffiths	London
Professor Gordon Hughes	Edinburgh
Professor Keith Lumsden	Edinburgh
Professor Paul Macavoy	Rochester, NY
Professor Donald Mackay	Edinburgh
Professor Anthony Ogus	Manchester
Professor Charles Rowley	Fairfax, VA
Professor Pedro Schwartz	Madrid
Professor Andrew Skinner	Glasgow
Mrs Linda Whetstone	Atlas Foundation
Professor Jack Wiseman	York

REGISTERED OFFICE
21 George Square, Edinburgh EH8 9LD
(Registered in Scotland No. 91239)

PUBLICATIONS BY THE DAVID HUME INSTITUTE

Hume Occasional Papers

No.1 *What do Do About the Over-Valued Dollar* - Ronald McKinnon

No.2 *The Political Economy of Pension Provision* - Alan Peacock and Norman Barry

No.3 *The Regularities of Regulation* - George J. Stigler

No.4 *How Safe is the Banking System?* - Richard Dale

No.5 *Economic Issues in Merger Policy (Out of print)* - E. Victor Morgan

No.6 *The Regulation of the Telecommunications Industry* - Bryan Carsberg

No.7 *The Novelist's View of the Market Economy* - Allan Massie

No.8 *Understanding Mrs Thatcher: Conservative Economic Policy 1979-1987* - David Simpson

No.9 *Adam Smith and Economic Liberalism* - Andrew Skinner

No 10 *Long-term Savings in an Enterprise Economy: A Case Study of the Principles and Practice of UK Economic Policy* - Jack Wiseman

No 11 *Contemporary Problems in Commercial Litigation* - David Edward, Lord Ross with a Commentary by Catherine Montgomery Blight

No 12 *Industry, Money and Markets: A Means to Irish Unification* - W Duncan Reekie

No 13 *The Future of Legal Systems* - Thijmen Koopmans

No 14 *Mergers and Takeovers: Short and Long-Term Issues* - Sir Gerald Elliot

No 15 *The Takeover Boom: An International and Historical Perspective* - Graham Bannock

No 16 *The Regulation of the Water Industry. The Office of Water Services: Structure & Policy* - Ian Byatt

No 17 *The Takeover Boom: Corporate Takeovers and the Interests of Regions and Local Communities* - Brian Ashcroft and James H. Love

Books

The Deregulation of Financial Markets
edited by Richard Dale, Woodhead-Faulkner, London, 1986

Governments and Small Business
Graham Bannock and Alan Peacock, Paul Chapman, London, 1989

Hume Papers

This series is now published by The Aberdeen University Press. Details are given in the enclosed leaflet.

Inquiries should be addressed to The Secretary, The David Hume Institute,
21 George Square, Edinburgh EH8 9LD.
Tel: 031 667 7004. Fax: 031 667 9111