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No 9

CORPORATE TAKEOVERS - THE NEED FOR FUNDAMENTAL RETHINKING

Allen Sykes

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INQUIRY INTO CORPORATE TAKEOVERS IN THE UNITED KINGDOM

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1990

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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 ninth 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.

A note on the Institute and a list of its publications appear on pp .66-68.

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

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1. INTRODUCTION

The efficient use of resources is a main pillar of capitalism. One of the most important ways such efficiency is achieved is by change of ownership of assets whenever a new owner is willing to pay more than such assets are worth to their existing owners. In the case of corporate assets, i.e. companies, this occurs either by agreed merger or by agreed or hostile takeovers. (Hostile takeovers are an expression of superior market power in the 'market for corporate control'.) Hostile takeovers are mainly confined to countries (notably Britain and the United States) where long term finance comes primarily in the form of equity from institutional and individual shareholders. Their shares are traded actively on stock exchanges. This method of finance pioneered the industrial revolution in the English-speaking world.

There is now widespread criticism over the consequences of the system of raising long term corporate finance primarily in the form of equity capital compared with the alternative form of the capitalist system which dominates most of Continental Western Europe and Japan. Here corporate finance is typically supplied via long-term bank loans with the banks also having major shareholdings. In these countries, generally conceded to have the most dynamic economic performances, hostile takeovers are rare. It is persuasively argued that the owners of companies in Western Europe and Japan are much more stable than in Britain and the United States, and that they can and do take a longer term view of corporate performance to the clear advantage of their companies and countries. In short, hostile takeovers are said to harm British and American corporate performance. There are widespread calls that '. . . something should be done about it', hence the Institute's Inquiry, among numerous other initiatives.

In this brief paper I shall examine some of the main issues for Britain from the perspective of an international businessman. Let me say at once that I am a strong, lifelong supporter of

free markets. I have worked in both monopolistic and competitive industries, and while the latter are often uncomfortable they are vastly more efficient and stimulating, and much to be preferred by most capable participants as well as all consumers and taxpayers.

I have experienced takeovers throughout my business life. Mostly I have worked for successful companies who made numerous agreed acquisitions and mergers. My only direct experience of hostile takeovers was the unsuccessful 1988-89 Minorco bid for Gold Fields, followed by the successful Hanson bid in the summer of 1989. I naturally regret losing, but bear no resentment over the process. Management have no rights to tenure, nor should they. Further, losing a takeover battle is no automatic slur on management. Sometimes companies are taken over precisely because they are successful, but could be even more successful in another and wider grouping. Also, many acquirers pay too much for companies by misjudging values. Defeat need neither involve nor imply incompetence.

On a final personal note, I confess some sympathy with the views of two well known and successful Anglo-American practitioners of hostile takeovers, Sir James Goldsmith and Sir Gordon White. In a fairly recent celebrated public debate (Reference 1)* James Goldsmith regarded 'agreed' mergers with special scorn as being motivated by either management aggrandisement or mutual protection. Directly and indirectly I have experienced some agreed mergers that merited just such a harsh description although most did not. Further, in a recent article (Reference 2) on why corporate management must be accountable, Sir Gordon White correctly defines so-called 'hostile' takeovers as those where the hostility comes from the incumbent management against the predator. (If the hostility came from the majority of shareholders no hostile bid would be possible). Again I must agree, although I also accept Sir Gordon's careful and fair qualification that sometimes such hostility is with just cause although frequently not.

My point in quoting these two leading exponents of 'hostile' takeovers is to draw attention to the fact that the legitimate concern of all those opposed to hostile takeovers needs to be extended to *all* mergers and takeover activity since agreed deals may not be in shareholders' or the national interest.

I do not deplore hostile bids as such. Hence, in the course of this paper I shall examine the desirability of the absence of hostile takeovers over much of the UK corporate scene, caused by all manner of bid-proofing devices including, in recent years, the creation of 'golden shares' by the government in most of the newly privatised companies. In sum, I shall try to examine the takeover and merger scene over a fuller canvas than is normal, and hope that others in the debate may be encouraged to follow.

2. THE SUGGESTED FUNDAMENTAL CRITERIA FOR JUDGING TAKEOVERS

In too much of the merger and takeover debate the criteria of the participants are often generalised slogans or oversimplified statements, and that is true of many on all sides of the issues. On the one hand, in what I shall call the broadly 'protectionist' lobby there are pleas for stability, managed change, protection of strategic firms and industries, and protection from foreigners, especially from foreigners with different takeover rules or environments. There are also pleas for the protection of special interests. Workers and regions figure prominently in these lists but never consumers and taxpayers whose interests are almost universally ignored. The interests of incumbent managers, presumably out of delicacy, are largely unmentioned. On the other hand, the often equally strident 'market forces' lobby is also given to oversimplified sloganising. Here it is urged that, apart from monopoly avoidance, market forces must reign completely freely, no threats from foreigners need be heeded, competition is the sole good and there is little to worry about in the present scene.

I have little sympathy with the more exaggerated claims of either lobby. If the debate is ever to reach useful conclusions, however, it is necessary to be more precise in establishing the relevant fundamental criteria for judging mergers, agreed or hostile takeovers, and the absence of such activities by the toleration of protective devices. (My own bête noir is the almost total neglect of the consequences of takeovers by inefficient bid-proof companies which are freely allowed to extend their scope for the inefficient management of assets, and thereby reduce the area open to competition, of which more later).

Any view of fundamental criteria is subjective but I hope my views will commend themselves as the most appropriate. I believe that the most important single criterion for judging the issues for Britain should be how best to achieve optimal long-term efficiency in the use of corporate assets in Britain, regardless of nationality of ownership, and of assets owned by British firms abroad. I readily accept that in most cases competition in the market for corporate control best promotes this criterion, but not in all cases as I shall discuss. Competition, correctly viewed, is a *means* to the end of efficiency, and in most cases it is a sufficient means. Nevertheless it is a means and not the end. Failure to make that distinction has muddled the takeover debate.

I am also sympathetic to the *occasional* justification for preserving from foreign ownership a strategic industry or firm where a strong case of public interest can be made. This is a suggested further criterion although it could as properly be said to be included under the criterion of long term efficiency, since long-term national efficiency cannot be entirely divorced from the issue of the general extent of foreign ownership. It is a sufficiently important requirement in practical and political terms, however, to be considered as a separate criterion.

These are the two criteria, certainly the two main criteria, against which I believe and recommend that takeover and merger issues should be judged and which I have used

throughout this paper.

I have omitted the other two criteria for judging takeovers which are frequently advanced, namely the protection of jobs and of regions, both of which have been carefully examined in all the earliest papers in this series. My omissions stem not from lack of sympathy but from doubts about whether the prevention of mergers and acquisitions is an appropriate and efficient way to advance what are essentially social aims. Virtually every measure of job protection tried in Britain in post-war years has achieved exactly the opposite effect. The Dock Labour Scheme and its perverse extension in the mid-1970s is but one prominent example amongst many. As for regional protection, it is equally possible to argue that by cushioning certain areas from the full rigour of economic forces such regions have not made the necessary adjustments sufficiently or in time. In short they have been weakened not strengthened. Good intentions have often failed.

The protection of jobs and regions may well be desirable social policies. If so, they should properly be a charge on national taxpayers, not randomly levied on shareholders in certain companies, an arbitrary and indefensible procedure. Because I do not consider the protection of jobs or regions a relevant subject for mergers and acquisition policies, I shall seldom refer to them further in the rest of this paper.

3. SERIOUS FLAWS IN CORPORATE GOVERNANCE

It is not possible to discuss usefully the pro's and con's of takeover and merger activity in Britain without first considering the state of health of corporate governance. The legal and economic theory we have all been brought up on, but scarely believe and seldom discuss, is that publicity quoted companies are run primarily for the benefit of shareholders by their senior management whose interest closely parallels that of shareholders, under the control of effective, disinterested non-executive directors. The facts are otherwise. Most shareholders

of public companies are at best passive owners leaving a massive power vacuum and one which non-executive directors, however capable, cannot fill satisfactorily.

a) Shareholders and Annual General Meetings

The effect of British shareholders on corporate governance is in practice slight until there is a major crisis such as a hostile takeover, or a serious scandal. One of the best ways to judge the reality of shareholder control is to examine the typical company annual general meeting. Approximately 30% of shareholders are individuals. They are the overwhelming bulk of the attendees at annual general meetings but it would be rare for them to represent more than a few per cent of the totality of shareholders. The majority tend to be either pensioners coming for a form of annual reunion or elderly investors with small holdings and time to spare. (Busy people rarely attend non-events which is a fair description of most corporate AGMs). The interests of these small shareholders are usually personal and their questions seldom test even half-asleep chairmen. They tend to be loyal to management and forbearing of slackness and inertia. They rarely raise a matter of serious consequence, still less press it to a serious discussion, and almost never to a vote. For them the AGM is a pleasant annual social outing. If the board lays on films, exhibitions, and especially food and drink, they can be sure of a much larger and friendlier attendance than if they do not, but the quality of questioning will be little changed.

The only other noticeable attendees at selected AGMs will be those with religious, political or environmental interests, usually with a very small shareholding (one share would be the most common). Their motives for attending are those of public protestors. They have little direct interest in or knowledge of the company concerned, especially of its business policies. It is usually the case that once a company comes under prominent attack from one or more of these groups, that attack will continue for many years, sometimes for a

decade or more at subsequent AGMs (e.g. RTZ), and often occupies the greater part of the meetings. Whatever this may do for the causes of the protests it is observable that such regular disruptions still further reduce the already limited business usefulness of most AGMs and in consequence reduce further the few serious attendees interested in the performance of the companies concerned.

There will usually be a sprinkling of institutional shareholders' representatives at AGMs (from insurance companies, pension funds, investment and unit trusts). They usually disdain to take any part in the proceedings. The institutions like it be understood that as the majority shareholders (they typically own 70% of major companies and this will usually be held between 20 and 30 institutions) any representations they have will be made directly to the boards concerned, in private. But, and I am sure I speak for most experienced directors, it is rare for institutional investors to seek serious meetings with companies in any but crisis circumstances. As the Association for British Insurers candidly admits in its evidence to this Institute's Inquiry (Reference 3)* they can only deal with a number of carefully selected cases each year because of an admitted lack of resources. (As their income depends entirely or mainly on investment performance, depending on the institution concerned, this is a remarkable admission which should excite major concern amongst their owners. The fact that it does not, tells us much about shareholders and trustees on which I comment later).

With only this group of attendees at nearly all public company AGMs it is small wonder that boards of directors seldom have to take them at all seriously. My earliest business memory as a junior manager in a great international British company over thirty years ago was being asked, along with some four hundred other junior employees, to attend the AGM to make the audience look respectable. But for this organised effort the board would have outnumbered the audience! Even then, the business of the meeting seldom occupied more than twelve

minutes, and to avoid embarrassment at such a brief annual account of stewardship, the chairman took to making a major forty minute statesmanlike address on some major topic of the day. I attended five such AGMs and never heard a single challenging or penetrating question, despite the ups and downs in the company's fortunes.

Throughout my career I have usually been part of the farcical preparation of the 50 to 100 most difficult questions that could be asked at the forthcoming AGM, and the soundest answers to them. In over thirty years I cannot recall ten of the questions ever being put, and the prepared answers were nearly always accepted without any supplementary questions or further challenges. Further, almost never was a serious unforeseen question put. Finally, whether the results for my first corporate employer were good, bad or indifferent (they were all three over the five years) a very elderly stockbroker, quite unprompted, always praised the board and proposed a vote of thanks. It scarcely amounted to a serious annual reckoning of accountability.

In my experience of British public company AGMs, what I first noticed over thirty years ago has changed little in substance since. The boards of public companies are not held to serious account at annual general meetings, nor at the rare and usually unrepresentative private meetings with institutional shareholders. In sum, they are not in practice accountable to their shareholders at all save in occasional crises. This has profound effects for the pressures (or rather lack of them) for optimal efficiency to which boards are supposed to be exposed. It may justify the need for the blunt occasional correction by the threat of hostile takeover. In the absence of any other serious regular financial discipline and accountability, how can it be fairly criticized?

I shall have more to say about institutional shareholders, but first it is appropriate to consider the way boards of directors of public companies work in practice in Britain.

b) Boards of Directors

I have argued from experience and observation that in practice British boards of directors exist in a vacuum. They are largely unsupervised by the general run of normally passive shareholders. Given the vacuum, they have not unnaturally turned in on themselves and their own interests predominate. They are mainly accountable only to themselves until the threat of hostile takeover looms, or until they fear the possibility of such a threat. These are not negligible constraints, but in practice they are the only serious constraints in the British system of corporate governance.* This *ought* to be why advocates of the free market school are so reluctant to countenance protective corporate devices, for if they were to become common, then boards would have almost total freedom from accountability, which is self evidently indefensible. (I use the word 'ought' advisedly. If it were widely accepted that threat of takeovers was usually the only serious discipline then the present free market model would be seen to require major amendment).

In law, directors are responsible for the affairs of companies and no distinction in responsibility is made between executive (full-time) directors and non-executive (very part-time) directors. In practice, with the generally good legal and accounting advice available, few boards of major companies transgress the law, and lawsuits for negligence are extremely rare. Hence, at present, the legal exposure of British public company directors is not a matter of practical concern, unlike their American counterparts.

Boards of directors, given the vacuum within which they

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*Throughout this paper I am *not* saying that companies are free of all or most constraints. Nearly all companies face some competition in their markets and this is usually the main spur to efficiency. The point I am making is that the desirable *complementary* restraint of effective corporate governance is often weak or largely absent for long periods and this much to be regretted.

mainly exist, are inevitably self-perpetuating. The chairmen and a few of the most senior executive directors effectively control the nomination of executive director candidates and it is rare for their nominees not to be accepted. The chairman and sometimes existing non-executive or senior executive directors usually choose the non-executive director candidates, and it would be unusual for their recommendations to be challenged. (A non-executive director likely to take a hard line with the chairman and executive directors is unlikely to chosen). Almost never do institutional shareholders put up candidates, nor do they see that as their function despite the huge importance of investment performances in their own businesses. Apart from usually frivolous nominations at AGMs, individual shareholders also very rarely play any part in choosing the board. Few directors have ever been refused election or voted off boards at AGMs. In sum, there is little independence or discipline involved in the ways by which the supreme governing body of corporations are chosen.

Given the way boards are chosen, and the fact that for most of the time they operate in a power vacuum, it should not be surprising how seldom they hold the chairman or managing director (chief executive officer) or both to account. The executive directors usually owe their position to one or both of them, and most probably, their future.

Non-executive directors are certainly more independent and on the few occasions when a chairman or managing director is fired, they will usually have been the catalysts. But how rare such firings are in Britain, far rarer than the number of disappointing company performances would seem to merit. Would it be reasonable in the circumstances, however, to expect anything else? Lawsuits for the negligence of British boards of directors are unknown. Non-executive directors typically get paid only £10,000 to £20,000 a year for between ten and twenty days work, which given their general level of competence and experience, is a modest reward for the apparent responsibility. They suffer, however, no unpleasant

consequences for other than gross failure of the companies on whose boards they sit, and receive no reward at all for any superior corporate performance. Accordingly it is not surprising that in the circumstances most non-executive directors do not constitute a formidable discipline on the boards on which they sit. In saying this, I am not criticising them. The way corporate governance in Britain is organised does not put pressures on non-executive directors to behave in a quite different and more influential way. Individual non-executive directors who try regularly to exercise their powers more firmly will usually not be supported; hence the rarity of non-executive directors resigning en bloc from inefficient companies they cannot change.

c) Frustrated Management Ambitions

Before returning to the power or ownership vacuum at the heart of British corporate governance, it is necessary to consider briefly a major frustration in the senior management of quoted British companies. Given the negligible contribution or involvement of shareholders, a large number of senior managers, including nearly all of the best, resent the disparity of rewards between management and shareholders. If a small senior team take a £500m company and turn it into, say, an £800m company (in real terms) in, say, five years, they resent receiving rewards only the form of salary, bonuses and small stock options which are dwarfed by the increase in corporate value for which they have been largely responsible. There is felt to be far too great a disparity in reward for effort. It is this which has fuelled both very high salaries and some very large performance-related bonuses for a handful of star performers and the huge interest in and increase of management buyouts and buy-ins (MBOs and MBIs). That something is clearly wrong with the present system is evidenced by the often incredible release of energy in managers who become owner-managers. The same people who may have been merely competent or even indifferent performers in some mundane division of a company often transform its performance and

their and their staff's rewards compared with their previous employment. Waste, staff and costs are cut rigorously, corporate perks dispensed with, fashionably located offices sold off, etc. As thinkers from at least Adam Smith to Milton Friedman have observed, no-one spends other people's money as carefully as their own. Not all MBOs prosper, nor is it to be expected given the risks, but on average they seem to lead to markedly superior performances. This release of profitable energy demonstrates that British managers can work much better under the right system of incentives (and equally profitably involve and motivate their staffs who typically are participants or have much better incentives than before). It is not present managers who are to be criticised for these different performances of the same job *but rather the present system of corporate governance*. If the present system could in large part be replaced by *a system of proprietor-owners* rather than by a continuation of the combination of largely powerless owners (most individual investors) and absentee owners (most institutional investors) that reigns at present, the difference in performances would be remarkable.

It is now appropriate to reconsider the actual way most institutional investors discharge or otherwise their ownership responsibilities.

d) The Passivity of Institutional Investors

In Britain (and the United States) corporate activity is dominated by publicly quoted companies, *freely* traded on the Stock Exchange to a much greater extent than in the countries of Continental Europe, Japan and the newly industrialising countries (NICs). In these other countries, private corporations with owner-proprietors are much more dominant. Further, and most importantly, in the publicly quoted companies bank lending is far more important as the source of long-term finance, and banks (notably in Continental Europe) are usually important or dominant shareholders. In other words the effective owners of companies in these countries are far closer

to management and exercise proportionably greater influence. And such influence is felt both frequently and regularly. No one with experience of these countries would deny that corporate management there is generally efficient and subject to clear and rigorous disciplines. Poor performance is much less tolerated and managers are more frequently replaced than in Britain. While exact proof is impossible, nearly all experienced observers and commentators believe that this system has produced generally superior corporate performance in these countries, which is reflected in their generally superior national economic performance. This is not to deny the importance of cultural factors which work strongly to enhance business performance, particularly in the leading countries concerned, most notably in Germany, Japan, Switzerland, and many of the NICs.

The contrast with British investors, particularly the dominant institutional investors (70% and growing), is stark. By their own frequent admissions they seldom exercise direct influence on companies and do not provide the resources or expertise to do so. If a company underperforms, their usual response is to reduce or eliminate their investment, leaving the task of change to their successors or to the board concerned. In sum, they are largely absentee owners who prefer to sell out when performance fails.

This phenomenon has often been remarked upon over the last few decades in Britain, the United States and the other English-speaking countries with similar dominant stock exchange systems. Only recently, however, has the full weakness of the system and the damage it causes to national economic performance become more apparent. The process of clearer realisation has undoubtedly been spurred on by reactions against the high volume of hostile takeovers in recent years, particularly in Britain and the United States, high in comparison both with earlier periods and very high in comparison with other nations. (See in particular the analysis in Reference 4*, an earlier study in this series of Institute papers).

It is now becoming more fully appreciated that institutional investors in Britain (and the other countries with dominant stock exchange systems) do not regard themselves as active participatory owners but as passive investors, free to opt out when circumstances are no longer favourable. In practice, selling out of large companies is difficult and time-consuming, and most institutions wait for and often welcome takeovers to restore the position. Institutional investors have been well described in a recent and particularly perceptive supplement in the Economist ('Capitalism' - see Reference 5*) as 'Punter - Capitalists', i.e. investors who feel free to chop and change frequently, i.e. to trade in shares but not, in general, to discharge the responsibilities of owners.* It is this which causes the power vacuum at the heart of stock exchange systems and thereby removes *constant and informed owner pressure* for corporate efficiency. In the absence of any other major disciplines, hostile takeovers are the main substitute, and however unsatisfactory they may seem on occasion, whoever criticises them needs to propose a superior alternative.

In my experience and observation contacts between boards and their institutional investors are infrequent and generalised in normal times. They usually comprise either an occasional discreet lunch between senior institutional representatives and the senior executive directors of companies, or more commonly, a combined meeting of quite junior institutional representatives at a lunch or presentation organised by a company's stockbrokers, or by the company announcing its annual results. In either case the meetings are short, lightweight, generalised sessions and a far cry from a searching and expert inquisition on management performance, with follow-ups and unpleasant consequences for indifferent performance.

Under threat of takeover, both forms of meeting will be more

*I should add in relation to Reference 5 that it has considerably helped and clarified my own understanding of the subject of takeovers. Readers of it will see my debt to its author throughout this paper.

frequent, with the threatened company taking the initiative. The primary mode of communicating, however, will continue to be with junior institutional representatives. There is little flavour of management talking to informed and active owners at such meetings. They are usually characterised by management trying to justify to sceptical analysts half their age why they should not sell out to the bidder. It is hardly a reassuring process.

Again, I have no wish to criticise the investment institutions as such for their actions. They have never pretended to operate differently nor are they staffed or organised to do so. And if a few institutions tried to take an active ownership stance on a regular basis it is doubtful if they could effect much change. The majority of institutions would need to embrace new policies and organise themselves to implement them.

It should also be borne in mind that the investment institutions have come to be the dominant corporate shareholders partly through the encouragement of the tax system which channels most personal long-term savings to them. They see their duty as getting the best for their shareholders, policy holders or pension clients as the case may be. Further, business boards are ill placed to point a critical finger at this method of working when their own pension funds behave in the identical way

What I have described is the current corporate governance reality of institutional share ownership in Britain. That reality has major consequences which need to be addressed by all who participate in the takeover debate.

In the light of my analysis of the serious flaws in British corporate governance, I turn next to an evaluation of the main opposing views on takeovers and mergers before considering proposed remedies and then advancing my own recommendations.

4. EVALUATING THE MAIN OPPOSING VIEWS

It would be presumptuous of me to claim to have identified all the main views on the subject, or to have done them full justice. In what follows, however, I will give my best brief appreciation of the main views as I perceive them and my analysis of their strengths and weaknesses. Before doing so, I would emphasise the need for humility by all of us participating in this important debate. Such factual evidence as exists on the benefits or otherwise of mergers and takeovers is at best incomplete and at worst, misleading or ambiguous. If other countries where hostile takeovers are rare perform better than Britain, the main reasons may lie far from the takeover field, and what works for them may not happily transplant here.

Numerous studies of mergers and acquisitions have reached the view that they result in no demonstrable improvement in long-run corporate performance and that rather more than half show a worse trend. Many of these mergers and acquisitions, however, may have been for management protection as Sir James Goldsmith argues (Reference 1). And who can say what the performance of companies remaining independent would have been but for the threat of hostile takeover? The improved performance and partial adoption of the bidders' intended policies by many threatened companies, e.g. BAT over the last year, lend weight to this view. It is certainly a view I share because in too many industries not subject to vigorous competition it is hard to see what other financial disciplines exist. In this connection (see Reference 5) it is to be noted that most takeovers (and most MBOs and MBIs) have occurred in mature industries where managements may have become too complacent and comfortable because of market dominance (e.g. from the security of major brand names) and hence reduced competitive pressures.

In the end, support for the critical arguments will depend much more on judgment than on factual analysis. Too many

of the arguments put forward by both the protectionists and free market schools of thought are unsubstantiated prejudices and self-serving rationalisations. The subject is too important to be treated thus.

a) Short-Termism

No accusation has been advanced more widely and persistently in recent years against hostile takeovers and allegedly complacent institutional investors and their allies (particularly merchant banks and stockbrokers) - the 'City' - than that of 'short-termism'. Industrialists of repute have, for most of the last two to three years, inveighed continuously and strongly against this City attitude, and they have drawn blood. City spokesmen have both tried to refute the arguments, and in contradiction promised to make greater allowance for longer term factors.

The strongest complaints have come mainly from the capital-intensive industries with long construction lead times, and from many but not all industries where heavy and prolonged research and development expenditures are needed to ensure continued growth. The senior management of these types of companies have felt themselves under considerable pressure to increase short term profits and hence share prices by cutting back on critical investment in construction or research and development (R and D). They complain that the investment teams in the institutions are judged quarter by quarter on investment performance because of the often intense competition between the investment institutions, on industry suffering from marked overcapacity. A junior investment manager under pressure to maintain or increase his returns will be disinclined to wait several years for an investment to produce results since without better short term performance on the share portfolio he manages he may not hold his job for the necessary period.

I believe there is much truth in these and similar arguments. Early in my career in international mining with RTZ, where

we accomplished seven major world-ranking projects in the decade of the Sixties, it was apparent how seldom we were credited with the likely contribution from a new mine until it was six, or at best twelve months from going into operation. (I do not say we received no credit, but that what we did receive was far short of the underlying reality). RTZ's shares at at time of rapid profitable growth were thus frequently and seriously undervalued. I have had that experience repeated many times in my career, much of which has been spent on long-term major energy and natural resource projects.

I believe my experience is commonly felt in many similar industries. If the truth of that point is accepted, however, who is to blame? We industrialists have some grounds for complaint that too frequently our future is effectively in the hands of very young analysts and fund managers whose time horizons are often too limited to permit us to perform, and who anyway lack the experience and knowledge to judge expertly. (Who would ever appoint them to senior industrial management to make these critical judgments?) But how well have we generally made our case by expert, well-prepared presentations? Not well enough usually. But supposing we did do the presentations more thoroughly, would the institutions really take note, given their own priorities? It seems doubtful. Further, have they the expertise to judge the presentations? As presently staffed and organised, they could not cope with regular expert presentations on the necessary scale. As discussed above, they are generally passive owners. The contrast with the more informed banks with their long-term understanding of and support for R&D and long term investment in Germany and Japan, etc. is both marked and painful.

The phenomenon of short-termism is a complicated one and its roots are wider than the causes so far examined. In a perceptive and cogently argued recent article (Reference 6) John Plender, drawing upon recent British and American financial research, points out that the higher cost of long-term

capital for British firms puts them at a significant disadvantage in funding long term projects or long-term R and D, and the longer the required period, the greater the cumulative disadvantage.

John Plender ascribes the higher cost of capital to two main causes. First, firms in Germany, Japan, etc. rely on a much higher proportion of lower cost debt capital and consequently a lower proportion of equity capital such that overall their cost of capital is broadly only half that of Britain in real terms. (This willingness to fund more debt is likely to be the consequence of the greater appreciation of companies' true risks and profitability that comes from close ownership links, in sharp contrast to the position in Britain.)

Second, Britain's experience of high inflation, balance of payment problems and stop-go economic management has been a markedly less favourable climate for business and for a high proportion of debt finance than in Germany, Japan, etc. The solution to this difficulty rests with the Government and needs to be attacked through a more stable monetary policy and the progressive removal of distortions in Britain's finance, labour and housing markets.

The consequence of the higher cost of long term capital in Britain is to impose a double handicap. First, it makes all longer term investment expenditures significantly more costly. Second, British firms are valued less in relation to earnings, making Britain an international bargain basement for foreign bidders. Short-termism is thus much more than a clash of aims between industrialist and the City. To overcome it these other significant causes must be addressed also.

I conclude therefore that the often heated debate on short-termism is presently largely a dialogue of the deaf between those with rather divergent aims. Industrialists implicitly want the institutions to behave as long term, knowledgeable owners, but the institutions seek no such role. Successive governments have exacerbated the problem with macro-economic policies

and the toleration of market distortions that have disadvantaged British business against it main rivals. And the remedies British business has sought for governments have been mainly protectionist rather than those addressing more fundamental causes.

A last view which must be considered is that of the radical free market school. They imply that nothing is wrong with the present situation, the market knows best and will sort out all difficulties, no competent management has ever failed to convince shareholders when it had a deserving case, and no well managed company has ever been taken over involuntarily. It is true that it would be difficult to refute these assertions beyond all doubt: the evidence is not sufficient for the purpose. But if the process is reversed, how can this school of thought prove their main assertions? And if not, how confident dare they be in their prescriptions? I am a strong supporter of market forces but markets cannot deliver the best result if knowledge is not universally available to buyers and sellers (and patently this is not true of the worth of long term performance) and also if institutional structures are inhibiting, which from my analysis of the flaws in corporate governance and from the analyses of John Plender, the Economist, etc., I strongly believe to be the case. What we need are remedies to the present market imperfections. A justified belief in the efficiency of free markets should not be thought the same as a belief that the status quo represents the best that can be achieved. It is unlikely to lead to any worthwhile changes.

All that can be said with some confidence is that short-termism, certainly extreme short-termism, is itself likely to prove a transitory phenomenon. Many of the companies whose shares form the chips in the present casino-like takeover activity could not have come into being, or certainly not reached their present size, in current conditions. It follows that their supply is limited and reducing. Even where successful bidders 'unbundle' their victims for dispersed sales, the number of companies available or suitable for acquisition must fall. The likely end result is

far fewer, bigger and largely specialised companies. The demand for stock brokers, merchant banks, investment analysts and investment managers must inevitably shrink. The inevitable consequence of 'City' short-termism is long-term damage to the City on the back of far greater long-term damage to the corporate sector as a whole. The long-term health of financial services cannot be very different from that of the rest of the corporate sector from which it draws most of its business. The City should reflect on that.

b) Insufficient Protection from Unfair Foreign Takeover Bidders

The chorus of anger and protest that arises over the alleged insufficient protection of British firms from unfair or undesirable foreign bidders is second only to that which arises over alleged short-termism, and of course the two topics are linked. Many industrialists and independent commentators feel that major and strategic British firms are being unfairly acquired by foreigners because their shares are undervalued by a City in the grip of short-termism. The main industrial arguments, however, are twofold. First, it is correctly said that Continental and Japanese firms can bid freely for British companies whilst the reverse is not true. By the widespread toleration of various protective devices (cross shareholdings between friendly companies - a favourite Japanese device but common elsewhere - untraceable 'bearer' shares, restricted voting rights on large classes of shares, widespread investments by lending banks, etc.) hostile bids can rarely succeed. This is said to be unfair. Bids should be restricted or prevented until reciprocity obtains. Second, it is pointed out, again correctly, that foreign firms wishing to own companies within the EEC, before end-1992 EEC regulations could restrict external bids for EEC companies, can only do so freely by way of takeovers of British companies, being effectively barred from other EEC countries. Further, non-British EEC companies wishing to expand within the EEC other than by agreed mergers and takeovers, can do so only in Britain. We are thus the '... only

free entry port in the EEC'. Hence it is argued that British firms are being taken over both unfairly and, from a national viewpoint, unwisely, and Britain could be moving towards a colonial industrial status.

These fears are real and not entirely unjustified. The counter arguments of some Government ministers and the radical freemarket school are that nothing need be done for several reasons. First, all takeovers, but especially hostile ones, indicate new owners who can use the assets to better advantage and to Britain's benefit. Second, British firms take over far more companies by value than is happening here, and protection could well promote damaging counter restrictions to Britain's net disadvantage. Third, foreign countries without full freedom for hostile takeovers have an inferior system and are only damaging themselves. For all three of these reinforcing reasons, it is concluded that nothing need be done.

All three arguments have some flaws. First, if market and institutional imperfections are present in the market for corporate control, then undervalued assets may be passing into foreign hands to Britain's net detriment. (Manifestly this argument does not have to be universally true for all foreign acquisitions - few could argue that the British car industry has failed to benefit from largely foreign ownership - it merely has to be true for a significant proportion to be worth taking into account).

Second, while it is true that British firms take over more firms abroad by value than the reverse, that takeover activity is primarily in the United States, another open stock exchange dominated economy. By definition, hostile bids can hardly succeed in Japan or Continental Europe from which so many inward bids arise. There is a one-sidedness in the matter and the Government could actually seek early reciprocity. Over 20% of British manufacturing industry is foreign owned compared with about 5% in the United States. Is it seriously to be imagined that if the figure rose to 35%, 50% or more, that

the Government would be indifferent, or if indifferent, that some future government would not reverse matters? Few nations have long tolerated foreign economic domination and Britain is not likely to be one of them.

Third, most of the foreign countries concerned have significantly more dynamic economies than we have managed in Britain over any ten year period. They may well lack the phenomenon of hostile takeovers but they do have other effective mechanisms for achieving efficiency which deserve our notice. Only if we think we have nothing to learn or apply from these countries and run no serious danger from present policies is there a case for no action and no further consideration.

I do not have easy answers to the questions posed. As an EEC member and with the EEC rules under major review and change, it is not obvious what Britain could and should do. The first step to sensible policies, however, is the objective recognition of existing realities by all concerned. That said, those dissatisfied with the present almost complete openness to foreign takeovers must put forward convincing and practical remedies which can reasonably be judged an improvement on the status quo.

There is one final matter to cover before leaving the difficult and contentious subject of foreign bids for British companies. This is the occasional discrepancy between the Government's professed policy and some of its own actions. The most significant discrepancy occurred over the sale of Rover to British Aerospace on controversial and in part on secretive terms - see Lord Young's public explanation (Reference 7).

The Government has stressed for some years in all official Department of Trade and Industry (DTI) literature its general welcome for foreign takeover bids (see for example page 34 of Paper No 4 to this Inquiry). The DTI rules also permit some allowance for employment protection. Professional advisers to British companies defending themselves against foreign

takeover bids, however, stress to the threatened companies that little or no weight will be given to these factors by the Office of Fair Trading (OFT) in deciding whether to recommend to the Secretary of State for the DTI whether or not to refer a bid to the Monopolies & Mergers Commission (MMC).

In Lord Young's explanation of why Rover was sold to British Aerospace rather than one of the many major foreign car companies active, or planning to be active in Britain, he stated that he and his officials took great account of the large number of jobs at stake in Rover and its suppliers which he said were more important than obtaining the highest sales proceeds. He also stated the importance of trying to keep ownership in British hands.

I have no fixed objection to these principles, but they are in marked contrast to the principles which the OFT follows in practice with British companies. It is inherently undesirable for the government to proclaim one set of principles for companies and to adopt a contrary one for one of its own corporate disposals. Either the Government should explain publicly why it had good reason in this particular case to depart from its long-proclaimed and enforced guidelines or it should widen the guidelines for companies. The Government may have had sufficiently good reasons for the sale but it damages its reputation not to share them publicly. It weakens respect for Government policies amongst too many worried industrialists.

c) Gaps in Present DTI/OFT Takeover Referral Rules

In this brief paper I do not intend to comment extensively on the present DTI/OFT takeover referral rules and practices, and how they are viewed by those affected. The rules and practices are set out clearly in paper No 4 to this Inquiry. Instead I wish to comment under this heading on only a few matters.

First, I believe it desirable that the criteria for reference to the MMC should be those set out in Section 2 above. In particular,

the *long-term* efficiency criterion should sensibly replace the competition criterion since it is wider and more relevant. It fully embraces the competition criterion but goes beyond it. An example, see Subsection e) below, would be a bid by a generally inefficient bid-proof company for a firm in another industry. No competition issue would arise but the possibility of newly acquired assets being used less than efficiently in the long term would arise and deserve investigation.

Second, in practice the only ground on which the Office of Fair Trading (OFT) can recommend a reference to the MMC concerns a threat to competition. Once the Department of Trade and Industry (DTI) accepts the recommendation, the MMC can, indeed is required to take account of all relevant public interest matters which sensibly are not restrictively defined. In other words, the grounds for reference are more limited than the ground of enquiry! This is perverse and should be changed. Clearly it must be possible for a merger or takeover to give grounds for disquiet on public interest grounds when no competition issues may arise. This dilemma would be overcome if, as suggested above, the *long-term* efficiency and strategic criteria were to be substituted for the present competition criteria. But even if my particular suggestions are not adopted, the present sole competition referral criterion needs amendment on the simple grounds of logic and consistency.

d) Improving the MMC's Resources and Capabilities

That the MMC has a difficult role no one with experience of it would deny. It has also been an increasing role over the 1988-90 period, but it may well be somewhat reduced when the full EEC mergers and acquisitions body assumes it supra-national powers at the end of this year. There are, however, some justified doubts about the MMC's present resources and capabilities and a need to augment them.

At present the MMC has something like a hundred permanent staff, a full time chairman and 32 part-time commissioners

who sit in panels of 6 at a time under the chairman or one of the deputy-chairmen. (See Reference 8 for a full description, Paper No 4 in this series and also official publications.) The permanent staff are widely held not to be overpaid, and many of the best are recruited by City firms after some years of relevant MMC experience. The part-time commissioners, a multi-disciplinary mixture of economists, lawyers, trade unionists, accountants and businessmen, are if anything worse off. They are paid what can only be described as an honorarium, of only £10,000 a year (1988), for their average week of 1½ days, the equivalent of £34,000 a year full-time. Not surprisingly, most commissioners are near the end of their careers or retired. These are quite uneconomic rates for so important and responsible a task. (Many judgments they are asked to make are of great complexity and importance.) Given the importance of their role, the pay scales deserve dramatic upward revision, certainly for the commissioners and the chairman, and whatever is needed for the staff.

There is also the need to attract more commissioners from the most senior levels of business with direct experience of the very large mergers and takeovers. As mergers and takeovers get bigger they often get more complex and the MMC must retain and, where necessary, add to its reputation for professionalism. The OFT's Director General of Fair Trading, Sir Gordon Borrie, has said in early 1989 of the MMC's sanctioning of Minorco's bid for Gold Fields in 1988/1989 that '... doubts still remained ...' in his mind. He went on to say, 'I am not being critical of the Monopolies and Mergers Commission, but they found it very difficult to get to the bottom of it all.' He added that perhaps only the tip of the iceberg was visible after the enquiry. I and my Gold Fields board colleagues would certainly endorse those doubts, although we were and are partisan in our views.

This leads me to a second matter on which doubts exist on the MMC, and this is the form of its hearings. At present, 3 months (formerly 6) are allotted for a referral. The first 2-4 week

period is primarily used for the two sides to make their submissions. There follows a 6 to 7 week period for consideration by the chosen panel of six commissioners. The remaining period of the 13 weeks is for the final report and recommendations. Neither of the two companies involved sees the other's submissions and each company typically appears only once or twice, occasionally more, before the panel, but always alone. In other words neither side ever knows what the other side has written in its submission or said at its hearings. I believe this to be profoundly unsatisfactory. MMC chairman, Sydney Lipsworth has described the MMC hearings as an economic arbitration, and in fact the MMC has extensive powers as a permanent Crown Commission equivalent to a court of law.

In all normal arbitrations or legal hearings each side states its case in the other's hearing and has every opportunity for cross examination. By this procedure, endorsed over millenia, the cause of truth is thought to be best served. Given the doubts about the MMC's effectiveness, particularly on the very complex issues, by authorities as important and knowledgeable as Sir Gordon Borrie, I believe this aspect of the MMC's procedure needs reconsideration. It will be objected that this could lengthen proceedings but Sydney Lipworth, the MMC Chairman, has said (Reference 8) that speed is never so important that it is worth sacrificing quality and thoroughness. Further, if there is long term logic to a takeover or merger then by definition it can stand some delay. To deny each side the opportunity hear and debate the other side's submissions, particularly on complex issues in hearings of major importance, seems not just inefficient but a denial of natural justice.

I believe my suggestions will be well supported by most businessmen with MMC experience, and ought to appeal to most of those with radical free market persuasions as being likely to improve the efficiency of necessary regulation in this field.

e) The Need for Some Restriction on Takeovers by Bid-Proof Companies

In general I do not favour adding to takeover restrictions but I do have some modest proposals for some restrictions on bid-proof predators. These were first set out in an article for the Financial Times (see Reference 10) on which this section of my paper is based. The case for restrictions on bid-proof predators has also been championed by the CBI but to no effect. If my proposals are properly understood, however, I believe nearly all industrialists and free market thinkers should equally be supportive.

The main reason for being concerned about takeovers by bid-proof companies is that if for any reason such a company operates an acquired company inefficiently there is no takeover remedy available.

As I have pointed out, nearly all major European and Japanese companies are bid-proof, as are a third of British quoted companies (measured by market capitalisation). The Government's merger policy should be refined to cover cases of bids from bid-proof companies, so that *where appropriate* they can be referred to the MMC on grounds of public interest. Present policy perversely enlarges the area of the economy controlled by companies immune from market competition since,if the bid is successful, the bid-for company becomes as bid-proof as the bidder.

The starting point for consideration should a be a broad acceptance of the Government's general monopolies and merger policy which encourages the efficient use of assets by exposing companies to the threat of takeovers. The principal issue here is whether immunity from takeover sanction will result in bid-proof companies operating acquired companies inefficiently. Other factors can and frequently do replace the takeover as the ultimate sanction against inadequate management. An obvious factor is the existence of sustained and strong competition in the bidder and bid-for company's

produce markets.

Historically, as I have pointed out earlier, most companies outside the English-speaking world have been primarily financed by debt from banks and institutions which often also hold some equity. This has forced them to be active shareholders to protect their loans. Lenders have the power to withdraw their invested capital, a legal right to a return, and command over a large block of capital, making them a formidable restraint on managerial inefficiency. Most European and Japanese companies may be bid-proof but few of their managements can be complacent.

This contrasts with the mainly equity-financed companies in Britain, where shareholders have no legal right to a return on capital, no practical power of demanding repayment, and no common policy to improve inadequate management. Takeover creates a single shareholder and often remains the only viable sanction against serious managerial inefficiency. The Government is therefore right not to interfere with the takeover sanction lightly.

The public interest problem posed by the bid-proof company is that if it is not operating in highly competitive markets, and is predominantly equity financed, there remains no effective sanction against managerial inefficiency. This should be a major issue for merger policy.

The table shows the categories of bid-proof companies in Britain in 1989. The largest category is of those bid-proof by size, which is a matter of degree and may change with time. The criterion used here is a market capitalisation in excess of £5bn - nearly twice the size of any successful UK bid to date. Many such companies could also expect protection on competition or national interest grounds.

Bid Proof Companies as % of FT-Actuaries All Share Index

	%
Size alone	13.6
Privatised utilities*	9.4
Golden shares	2.2
Strategic *(apart from size)*	0.4
Other *(Legal devices or dominant shareholder†)*	9.7
Total	**35.3**

* Includes electricity, water and Government stakes in British Telecom

† 50% or more

The second major category (9.4%) is that of privatised major public utilities which are largely bid-proof both by size and by Government fiat. In total, when privatisation is complete, bid-proof companies will be over a third of the FT-Actuaries All-Share Index. A large proportion are also largely immune from serious competition.

A basic principle of merger policy should be to discourage generally protective devices. This would imply discouraging, if not making illegal, extensions of bid-proofing where these are based on legal measures, and removing Government-imposed restrictions. Such a policy would be consistent with the Government's policy of exposing companies to takeovers as a spur to managerial efficiency.

Efficient implementation of this policy would require automatic consideration by the OFT of bids by companies which have a capitalisation in excess of say £1bn where there is *prima facie* evidence that they are bid-proof, and either predominantly engaged in monopolistic operations, or operating inefficiently. The OFT would then decide whether there was sufficient *prima facie* evidence, despite the bid-proof character of the bidder, that the acquired company would be operated to an acceptable standard of efficiency in the long term. Efficiency should be

measured in purely financial terms - such as an acceptable return on capital which is not derived from monopolistic activities. If the OFT were not fully satisfied by the evidence, referral to the MMC should take place.

This policy would seldom involve referral of EEC bids to the MMC because their lenders impose high standards of efficiency and many companies are in highly competitive markets. The proposed policy would involve referral of bids from the newly privatised utilities. This policy could be made effective immediately, since the 1963 Act and the new proposed legislation admits referral on public interest grounds.

If these proposals are accepted, bids from inefficient bid-proof companies would be prevented without interfering with the majority of bids or risking foreign retaliation. This extension is necessary. Without it, the Government may be forced to condone UK companies adopting bid-proofing devices. It could also face a new wave of economically unjustifiable acquisitions by privatised bid-proof utilities.

The takeover sanction is presently a major contributor to corporate efficiency. The Government should not permit it to be curtailed without full and sufficient reason. Enough is enough, and 35% of the market immune from the takeover sanction is already more than enough.

Two final points. If the above modest proposals are accepted then it will strengthen the fundamental criteria I have urged throughout this paper, namely promoting the long-term efficiency in the use of British and British-owned assets. Acceptance of the proposals, however, does require that there should be an initial OFT scrutiny of companies where mergers would make them bid-proof. Second, the Government should review the general wisdom of creating bid-proof companies (e.g. with 'golden shares') when undertaking privatisations.

f) The Case for Reducing the 30% Rule

The present Takeover Panel rule on takeovers (Rule 9 of the 'City Code' on Takeovers and Mergers) is that any company which acquires 30% or more of the shares of another company must bid for 100% of its shares. This rule is coming under increasing scrutiny. By setting the level so high it permits a predator to gain a powerful presence in a company which it can maintain indefinitely. By getting to between 25% and 29.9% a predator can then have major influence and sometimes de facto control unless the Board is very robust or other supportive shareholders in aggregate hold similar proportions. Where these two conditions are absent there is the clear possibility of a semi-crippled company which flouts my suggested fundamental criterion of long term efficiency.

I believe the case can be made to reduce the trigger threshold to 20% or even 15%, but certainly well below 25% where the ability to block key board resolutions is enshrined by statute. This prevents a would-be predator disturbing the conduct of a company for long periods as permitted by the present 30% rule. In support of this argument, two further points need to be borne in mind. First, at the AGMs of even substantial companies, Boards can seldom count upon automatic proxy support for board resolutions above 12% to 14% thus permitting a hostile 25% - 29.9% shareholder large *negative* powers. Second, a really hostile 25% - 29.9% shareholder could, by its negative support of the Board, prevent optimal profitability and thereby gain the chance to bid a few years later for the whole company at a reduced price. Such powers are inherently undesirable and should be changed.

Finally, it has not infrequently happened that a potential predator has acquired 15% or so of a company and not made its intentions clear for a period of a year of more, thus destabilising the company. Such circumstances may well discourage a management from longer term planning, to the clear detriment of the majority of shareholders. Such actions

deserve to be curbed.

In the light of these dangers I believe a strong case exists for reducing the compulsory bid level to at least 20%, and preferably to 15%. This would be in full comformity with the recommended long-term efficiency criterion.

g) Accounting Reforms to Reduce Short-termism

As set out in Subsection a) above, short-termism is a worrying phenomenon with a number of causes. There are, however, two modest contributions which accounting can make to overcome the strength of short-termism. First, in the case of financial institutions, it should be compulsory in their financial accounts to take profits into consideration *annually* even though not realised through shares sales. This would prevent fund managers worried about their own job tenure from claiming in the current year the full credit of the difference between the original cost of the share, perhaps many years earlier, and the current price. In other words only annual profits (or losses) should be taken in account. This would reduce the tendency of fund managers to sell out to takeover bidders at a price which allows their account to be credited not just with the present year's share rise but all past rises as well. To be fully effective, the same changes should of course occur in the *management* accounts of all financial institutions.

A second proposal worthy of implementation is that set out by David Collinson of the Department of Accounting and Finance in the University of Dundee in a letter to the Financial Times Editor on 18 July 1990. To encourage shareholders to take account of all relevant expenditures promising long-term benefit, he proposes that companies should publish annually the figure (presumably audited) of 'investment per share' or IPS for short. It would include expenditure on research and development, training and marketing and, of course, conventional capital expenditure. This is a simple, easily executed proposal which deserves implementation.

5. A CONSIDERATION OF PROPOSED REMEDIES

The concerns about the effects of the present takeover situation in Britain have led to a number of remedies being proposed, particularly from the broadly 'protectionist' school, and to one or two proposals for reducing even the present minimalist regulations from the radical free market school. There have also been some more imaginative proposals, notably from a prominent American lawyer and from the Editor of the Economist. I shall review these various proposals in this section and reserve my own recommendations and summary comments for the final section.

a) Increased Protection

Over the last two years of unusually high takeover activity in Britain (where 4 out of 5 takeovers in the EEC have occurred) serious concern has been expressed by worried industrialists, concerned public figures and thinkers even of a marked free market persuasion (see for example, Reference 12). No important survey of their concerns can justifiably reject them outright and argue that such concerns are misplaced, although I believe it right to be more sceptical of many, indeed most of their proposed remedies. What is quite unfair, as has happened with many commentators and some Government spokesmen, is to dismiss their proposals outright on the grounds of vested interest. While it is always appropriate to scrutinise carefully the arguments of anyone with vested interests, it is quite unjustified and illogical to assume such arguments must automatically be false. An innocent suspect accused of murder has a vested interest in defending himself and in obtaining justice, but that vested interest does not turn innocence into guilt. Often, arguments in any sphere will be put forward mainly by those with a vested interest, but without such an interest they may never have acquired the knowledge and experience which underlie their arguments. I believe we all need to consider the arguments on all sides of the takeover

debate strictly on their merits, for assuredly, important issues are at stake.

The main arguments of the protectionist school, as set out in the previous section, boil down to two. First, there is the not unjustified complaint of short-termism by institutional shareholders. Second, there are fears that detrimental foreign domination of too much of British business will occur before there is a level playing field within the EEC. Even when there is more equality, the different ownership systems of Japan and Continental Western Europe will always leave British firms disadvantaged by rivals largely immune to hostile takeovers. The end results of the two arguments are said to be that British firms will be forced to neglect long term growth, will tend to be undervalued, that a high level of hostile takeovers will continue, that many of the predators will be foreign, and that the British corporate sector and thus ultimately the nation, will suffer compared with Continental Western Europe and Japan.

I generally support those conclusions. I recognise that it is difficult to prove them conclusively but, as I have pointed out several times in this paper, it is equally difficult to prove the reverse. Those who argue that there are no serious problems and that consequently nothing needs to be done must show why their arguments should command assent. And, as I have tried to show, the free market arguments ignore significant market imperfections and structural flaws.

One can generally accept the arguments of the protectionist school of thought without embracing all or even most of their remedies. The principal remedies put forward have been the following:-

i) Companies should be allowed to bid-proof themselves by all the devices available, including cross shareholdings, restricted voting rights for large classes of shares, 'poison pills', no votes for the first year or two of ownership, etc.

ii) All hostile foreign bids should be banned where bidding on reciprocal terms by British firms is generally impossible.

iii) Hostile bids by bid-proof companies should automatically be referred to the MMC. (By implication there should be a change in MMC requirements generally to disallow bids from this source, which if widely enough defined would exclude most bids from Continental Western Europe and Japan but seldom from the United States).

iv) Hostile bidders should be required to prove public interest benefit.

v) Hostile bidders should be required to pay the defence costs where a bid is, say, £100m or less.

vi) There should be automatic MMC investigation of highly leveraged bids.

In considering these proposed remedies it is important to remember that the majority of hostile takeovers have occurred in mature industries which have used their large cash flows to diversify, often unsuccessfully, rather than making bigger payments to shareholders. It is unwise to propose remedies which would defend the often slack performance of such firms which have been insulated from strongly competitive product markets, often by well established brand names. The remedies which might have more justification for under-supported firms with genuine long-term growth prospects, cannot be justified for many of the victims of hostile takeovers.

I consider the proposed remedies in turn.

i) Allowing Bid-Proofing

No management can justifiably argue for protection from competition, for how else could efficiency be achieved, shareholders protected, and the nation's economy fostered? The general argument for bid-proofing is misplaced. It would substitute the possibility of management abuse as a remedy against

the alleged ills of many hostile takeovers but who can say the cure would be preferable to the disease? It is an entirely unselective defence which would protect all the undeserving for the sake of certain victims with some publicly justified claims to relief. I suggest the argument should be rejected as clearly contrary to the national interest save for the carefully defined exceptions set out in Section 4. e) above.

ii) **Banning Hostile Foreign Bids Without Reciprocity**

The argument underlying this protective proposal is to ensure that British firms are not disadvantaged by hostile bids from Japanese and Continental West European firms. I have some sympathy with this. The remedy has three serious weaknesses. First, many of the firms which would be banned are highly efficient and would invigorate slack sections of British industry as has happened in the past (e.g. the car industry). Second, reciprocity would seem hard to achieve as it stems largely from a different system of corporate ownership and governance, rather than from disreputable legal restrictions. It could turn into a permanent ban.

There is, however, something to the strategic firm argument. I doubt if there would or should be public or political indifference to the majority of Britain's major firms coming under foreign domination. But this remedy also is too unselective. It would risk protecting all firms whether of strategic importance or not. Further, it would seem incompatible with our EEC obligations. With the EEC now one of the most dynamic groupings of countries in the world and 60% of Britain's international trade being with EEC members, it would not be acceptable, certainly in the long term.

iii) **Banning Foreign Hostile Bids by Bid-Proof Companies**

As the majority of Japanese and West European companies are largely bid-proof this proposal is very similar to ii) and should therefore be rejected for the same reasons. If the argument is put in the much more qualified terms strongly espoused within the CBI in early to mid 1989, there is more to be said in its favour. The CBI proponents sensibly dropped the adjective 'foreign' and did not seek a ban but rather an automatic referral to the MMC, presumably with some Government instruction that bid-proof predators should not be looked upon with favour. Again I consider the proposal is still too wide. Where a bid-proof company is efficient and likely to stay so there is no good reason to bar its takeover activity. Instead, I prefer the more modest but I believe entirely defensible proposals on bid-proofing as set out in Section 4. e), based on my original article (Reference 10). Here I recommended that the OFT should automatically refer to the MMC all bids by companies capitalised over £1bn where there is *prima facie* evidence that they are bid-proof and either predominantly engaged in monopolistic operations or operating inefficiently. (I also recommended the same approach with *agreed* mergers which raise the same issues.) These conditions, plus a requirement on the MMC to accept my suggested fundamental criteria (Section 2.) of promoting long-term efficient utilisation of assets and protecting genuinely strategic firms, should be properly acceptable even to the strictest adherents of the free market school.

iv) **Requiring Hostile Bidders to Prove Public Interest Benefit**

The proposal to require hostile bidders to prove public interest benefit, presumably at compulsory MMC hearings, has superficial plausibility. It would, of

course, greatly increase the MMC's workload since at present (see Paper No 4 in this series, the sections by the OFT and DTI) only a handful of bids is referred; hence much greater resources and perhaps some more widely experienced commissioners would be required. For public interest benefit of course, such resources would be justified. It is highly doubtful, however, if this plausible proposal is in the public interest. The Government has tried hard to withdraw from intervention in what are mainly commercial business decisions. It would go against the grain to require a hostile bidder to *prove* public interest. Such proof might be very difficult to demonstrate convincingly and goes against the spirit of English Common Law that presumes innocence and requires proof of guilt rather than requiring that innocence be proved. I reject it as unreasonable. It could well give inefficient management too much benefit of the doubt which contradicts my suggested fundamental criterion of long term efficiency.

It should also be noted that if this proposal were to be adopted then respect for the dangers implied should, in the interest of consistency, also require that *agreed* bids and mergers should be similarly examined, a proposal I do not recall being advanced by its advocates.

v) **Requiring Hostile Bidders to Pay the Defence Costs of Smaller Companies**

The proposal as put forward by its CBI proponents was to charge hostile bidders the direct costs of a successful defence where bids were for £100m or less. The rationale is to protect smaller companies (why just smaller companies if the principle is valid?) from expensive and time-wasting exercises indulged in too lightly by very much larger companies who can more easily afford the costs of a bid, so as to deter all but the most justified bids. One can have some sympathy

for the plight of smaller companies on whom costly disruption could be inflicted. The remedy, however, could result in much wasteful expenditure on defence costs. Very extravagant and long drawn out defences could occur with no penalty to the defending company's boards or shareholders since win or lose the costs would be paid for by the bidder. The unconstrained incentive to wasteful and unjustified expenditure could easily outweigh any benefits.

vi) **Automatic Investigation of Highly Leveraged Bids**

A feature of many notable hostile takeover bids (more commonly in the United States than in Britain) has been the unusually high component of high interest debt which of necessity has to be repaid within typically one to three years of successful bid. This forced debt repayment schedule causes widespread asset sales whether desirable or not, and puts great pressure on short term profits. I would accept that these consequences are often to be deplored as they may flout my main recommended criterion of long term efficiency. In fairness, however, in the case of an inefficiently diversified firm whose core is a mature industry, the unfavourable consequences may well not arise. An *automatic* MMC referral does not therefore seem to be justified. Selective referrals, however, are different and the OFT already has sufficient powers to make referrals on these grounds and occasionally does so. I see no good case for automatic referrals for highly leveraged bids.

b) Continuing the Status Quo

One implicit option in the takeover debate is to do nothing. While I cannot recommend more than two highly qualified proposals of the protectionist school it will be apparent from most of my paper that I do not support the status quo. Too many of the *concerns* of industrialists and independent

commentators of repute seem to me justified and deserving of attention, even if the protectionist *proposals* do not generally commend themselves. Further, I am also concerned at the serious weakness in British corporate governance that too often puts managements under insufficient pressure to achieve optimal long term efficiency. Finally, I believe that the general evidence from Japan and Continental West Europe for *continuous* and firm pressures for achieving long-term management efficiency is too great to be ignored. Accordingly I find it impossible to accept that the present British system of handling takeovers is in little need of improvement. Nor do I see how the radical free market school can ignore the unsatisfactory features of the status quo and our inferior performance compared with the other systems. I believe we all need to search very hard for major improvements.

I turn lastly to a consideration of two major proposals for imaginative change, those of Martin Lipton and Rupert Pennant-Rea, Editor of the Economist.

c) Martin Lipton's Proposals

In a recent Financial Times article (Reference 11) Martin Lipton, senior partner of a New York law firm, put forward a radical proposal for a new system of corporate governance designed largely to eliminate hostile takeovers and greatly to reduce the pressures for short-termism. Mr Lipton has long specialised in takeover defences and some of his critics describe him as the celebrated inventor of the 'poison pill'. Certainly he has provoked some spirited rejoinders, not least from Sir Gordon White (Reference 2), and from correspondents in the Financial Times some of whom see him as primarily wishing to extend his law practice specialisation of takeover defences to Britain. Quite how proposals, which if implemented would dramatically reduce takeover activity, could enhance his prospects of business is not entirely clear.

I know nothing directly of Mr Lipton but he has made a serious attempt to address the issues at the heart of the Institute's

Inquiry and I propose to treat that attempt on its merits whether or not he is a sinner bidding to be an angel.

Mr Lipton begins his article by asserting that institutional investors in the United States and Britain have great power without responsibility, and have been behind the takeover and buyout frenzy of the last decade, forcing short-termism on managements to the national detriments. He feels managements need to be free to plan for long-term growth and that proposals for institutional monitoring constitute interference in management rather than a proper discharge of the ownership function. He describes the present system of corporate governance as an anachronism from the days when shareholders were real owners and not transitory investors, and there were neither hostile bids nor pressures on corporate management for quarterly performance. He dismisses other proposals for improved corporate performance as not addressing the real malaise in Britain and the United States, which is in dangerous contrast to the encouragement by patient knowledgeable owners undertaking long-term planning and investment in Germany, Japan, etc.

Mr Lipton proposes a new system of corporate governance. He wants the majority of directors to be independent of management and for there to be only a five yearly meeting of shareholders. Directors would stand for re-election on their five year record and their strategic plans for the next five years. Shareholders would receive a well prepared five year summary of the last plan against outcome plus relevant information on industry averages, competitors' performance, etc. There would also be a detailed five year plan, the assumptions, expected returns, etc.

Any shareholder with 5% or more of the shares or £5m worth of shares would have the same access to the corporate proxy machinery as the management. If shareholders contest the quinquennial board election they could do so on the basis of either a different five year plan or putting the company up for sale and soliciting bids. The five yearly system would permit

companies to pursue long-term planning over a relevant period and reduce pressure to maximise share prices in the short term. Mr Lipton claims his system would remove institutional pressure to sell out to bidders between quinquennial elections, presumably on the basis that no extraordinary meeting could be called to replace the board. He claims that the prospect of proxy fights would exercise a continuous discipline on boards, but only over the five year period as a whole. He feels his system preserves ultimate shareholder control but gives management sufficient freedom to perform to the level of its abilities. He dismisses the notion that five year terms are undemocratic by analogy to major political elections every four or five years. Finally, he modifies the fixed five-yearly elections of the board by suggesting that an election could be called by, say, 20% of the shareholders if a company failed to meet 80% of its corporate targets for two consecutive years.

Mr Lipton does not pretend his system is perfect or fully worked out but puts it forward for debate. In view of widespread dis-satisfaction with the present system he feels the debate is essential, a view that has wide support.

As with any radical new proposal, criticism is easy and has been forthcoming (see in particular Sir Gordon White's spirited counter attack, Reference 2) even in the few weeks between the publication of Mr Lipton's proposal and the completion of this paper. The first point to note, however, is that it is a serious issue which is being addressed and that should be welcomed. Second, the scheme would give a management time to perform which is a clear improvement on the present position. It also has weaknesses, however, and these weaknesses are probably too great.

The first and most obvious weakness is that the scheme could easily give too much latitude to slack managements for too long. The safeguard of allowing contested elections after two consecutive years of operating a corporate plan reaching only 80% of its targets may not protect shareholders. If business conditions become much easier than was foreseen when the

five year plan was drawn up, so that a minimum acceptable performance should be much better than the plan forecast, shareholders would not be protected. Second, I greatly doubt the capabilities of investment institutions to judge what should be an acceptable five year plan when proposed. If this is so, then poor plans could gain acceptance and give a quite unjustified five year breathing space. Third, and most importantly, it is very difficult, if not impossible, to see how such a scheme could be introduced without damage. As the legislation would be passing through Parliament and before implementation date, there would be a tidal wave of takeover activity before the five year moratorium set in, thus undermining the very benefits the scheme is designed to secure. Fourth, and finally, it would be an experiment which, if it failed to work well, would set Britain even more at a disadvantage against Japan and Continental Western Europe.

For these reasons I cannot support or recommend the scheme, but I welcome the fact that it contributes to the debate and forces all of us with doubts about the present system to redouble our efforts to find something better. Finally, the *causes* of Mr Lipton's disquiet have yet to be addressed by his critics and confident assertions that the present system is quite acceptable are not convincing.

d) The Proposals of the Economist's Editor

The final proposals I shall examine are those set out in the Economist's Supplement on Capitalism (Reference 5) by its Editor, Rupert Pennant-Rea, which I have commended earlier and acknowledged my debt to it. In what follows I cannot fairly summarise a 20,000 word paper, all of which is good value. Instead, I can highlight only a few of the most relevant points.

The Supplement is about much more than takeovers but the Editor's main theme concerns the reality and meaning of current corporate ownership. His main worries are similar to those of Martin Lipton, and many more of us, namely that

there has been a breakdown in corporate governance in Britain, the United States and other English speaking countries compared with Japan and Continental Western Europe. The classical, *involved* and *knowledgeable* owner-proprietors of the last century have largely given way to institutional investors who regard their investment more like betting slips. Shares are bought at hopefully favourable odds to provide winnings which they hope will be large, hedged by numerous other similar bets (investments) on countless other companies. They do not feel responsible for the shares' performance, that is the job of the respective managements. If a share fails to perform it will be sold, or held only until a bid is made for the company. Owner-capitalists have been largely replaced by 'punter-capitalists' interested in early financial returns. This has created the power vacuum at the heart of corporate governance. It is not anybody's fault. Personal savings, in part because of tax incentives, but also for convenience and risk sharing, have mainly passed to investment institutions. At present these institutions do not have the interest or the capacity to act as proprietors either singly, or in aggregate. They are poor at acting together since ultimately they are in competition. What applies to the institutions applies even more to individual shareholders whose powers of corporate governance scarcely exist (see Section 3). Finally, non-executive directors, comprising as they do mainly executive directors from other companies, cannot and do not redress the balance.

The vacuum has been filled in part, primarily by hostile bidders. (The Editor points out that many of the great American corporate raiders are in fact heirs to a long tradition in American capitalism, that of the proprietor-investor). The vacuum has also been filled by aspiring owner-managers. Both have the same motive, to change the way companies are run and so to make money for themselves. Both forces are revolts against punter-capitalism.

In turning to remedies, the Editor singles out Berkshire-Hathaway (BH), a particularly successful American investment

holding company run by its chairman, Warren Buffet and its vice chairman, Charlie Munger. The firm is a long-term and preferably permanent investor in a handful of companies. Investments are rarely sold. BH describes its own senior management as 'managing partners' and its shareholders as 'owner-partners'. In sum, they are long-term, involved owners of a few companies they know and understand well. BH's performance has been consistently outstanding, and achieved by methods which are in total contrast to 'punter-capitalism'.

The Editor goes on to point out that this is the same tradition as Japan, Continental Western Europe and also the very successful newly industrialising countries (NIC's). In Germany and Japan there is the heavy reliance on bank debt by banks who are significant equity investors, and all manner of effective bid-proofing devices which virtually prevent hostile takeovers. In all these countries (and the rest of Continental Western Europe) private family companies also predominate, and are much larger in size and importance than in Britain or the United States. Investment institutions are less active but the Editor notes their growth in importance since the mid 1980s, and the incipient dangers this brings of the growth of 'punter-capitalism' in these successful countries.

The Editor does not see major reforms in the ways of institutional investors in Britain and the United States as likely, but rather the continuance of hostile bidding. (He notes the resultant reluctance of many private companies to seek stock exchange quotations). He does not put forward many specific proposals but expects to see fewer institutional shareholders as tax incentives are reduced, more owner-managers, more wealthy individuals with sizeable industrial shareholdings - in short a shift towards proprietor-capitalists. His main recommendation is that the governments of Britain, the United States and similarly organised countries, should put their weight behind a move to much more proprietor-capitalism by tax breaks and other measures. The most important complementary action is the ruthless promotion of competition

- a notion finding increasing sympathy in the bicentenary of Adam Smith's death. He ends on the optimistic note that capitalism is very good at changing itself for the better, which is why all the obituaries are about communism.

I wholly support Rupert Pennant-Rea's conclusions. The task now for all who are dissatisfied with both the status quo and protectionism is to find specific ways to implement the broad thrust of his general proposals.

6. CONCLUSIONS AND RECOMMENDATIONS

a) Summary Analysis

Britain is still in a period of very high takeover activity which could continue for some years. In recent years, four out of five takeovers in Europe have happened in Britain. Concern at the detrimental consequences of much of this takeover activity is now widespread even if the causes are not always well understood, and many of the proposed remedies leave much to be desired. Some remedies indeed would worsen corporate Britain's condition. I hope, however, that I have shown in my detailed analysis that there are justified reasons for serious concern and that leaving matters as they stand or assuming the problem away should not be acceptable responses.

I have diagnosed the problem as stemming in large part from serious flaws in corporate governance. In publicly quoted companies individual shareholders are largely powerless and institutional shareholders are essentially share traders in heavy competition with one another. Consequently there is a large power vacuum at the heart of corporate governance which boards of directors cannot fill. In parallel, there is widespread frustrated management ambition to share more in the rewards of success and to have a greater say in their own destiny. For capitalism to function well in a modern, developed country the corporate sector must function efficiently. This requires the knowledge and discipline which comes best from informed

owner-capitalists. Firms in Japan, Continental Western Europe and the Newly Industrialising Countries (NICs) are better served by far in this crucial area than firms under the free stock exchange system of the main English-speaking countries which permits and encourages hostile takeover activity, most notably in Britain. In these other countries, banks and other financial institutions provide long term loans to firms in which they are also major equity investors. They are informed and involved owners; they provide a continuous and knowledgeable discipline for managements and achieve generally superior results. These countries largely lack the discipline of hostile takeovers but in its place they have compelling and what is more, continuous pressures for long term efficiency.

Short-termism is the most obvious result of the free stock exchange system but its causes are wider than the flaws in corporate governance. The higher cost of long-term capital and the penalty this imposes on long-term research and development activities is one major cause. Poorer relative national macro-economic policy is another, combined with neglect of distorted markets for housing, labour and finance.

The causes of short-termism result in relatively undervalued British companies which attract a disproportionate number of foreign takeovers. This process is exacerbated by the British Government running the most open door takeover policy in Europe at a time when non-EEC foreign companies are particularly eager to gain a foothold within the EEC before 1992. Further, other non-British EEC companies cannot easily take over their fellows to boost their own position before 1992, save in Britain. The playing field for foreign takeovers is far from level. It may be possible for the Government to turn a blind eye to increasing foreign control of British business but if the trend continues to the point of major foreign dominance, as could happen, then the Government will choose to act. No government of a modern major power will long tolerate economic colonial status, and if it did a successor government

would reverse its policies, political treaties or no.

I conclude, therefore, that the present position should not and probably cannot long be left unchanged.

b) Some Proposed Remedies

In the remainder of this concluding section I shall consider the main proposed remedies plus proposing remedies of my own. This subsection b) includes my minimum proposals, with my more radical proposals given in subsection c).

i) Agreeing the Fundamental Criteria

Many remedies have been proposed to deal with at least some of the major concerns diagnosed in this paper. To evaluate remedies it is necessary to agree on criteria. I have proposed two fundamental criteria. First, the main aim should be to achieve optimal long term efficiency in the use of corporate assets in Britain (i.e. whoever owns them) and of assets owned by British firms abroad. (This is wider than the present maximum competition criterion although it embraces it). Second, strategic firms or industries should be considered for protection from foreign ownership whenever there is a strong public interest case, and this should take account of the *general* level of foreign domination of British business.

The first criterion will I hope commend itself unreservedly. The second criterion may command less assent for the good reason that many of our industries have greatly benefited from foreign involvement; some indeed have been saved from probably extinction (the car industry?). I believe it to be against the interests of achieving long term *national* efficiency, however, to maintain that no *general* level of foreign dominance of strategic industries or of industries in general is a matter for any concern. (Nor does the Government as evidenced by the sale of Rover to British Aerospace - see Section 4. b) - by the care taken in its numerous privatisations to preserve British ownership and by the protection of the main clearing banks

from takeover believed to be afforded by the Bank of England). That said, I believe that proposed foreign takeovers of certain strategic firms and industries need to be considered by the Office of Fair Trading (OFT)and referred for consideration in all cases of doubt to the Monopolies and Mergers Commission (MMC). Acceptance of these views will require the strengthening of both the OFT and the MMC, and the provision of additional resources. Further, to prevent undue delay in OFT investigations when foreign bids emerge or mergers are proposed, the OFT would need to draw up and analyse in advance a list of potentially strategic firms and of any strategic industries where the level of foreign dominance has become a matter of potential national interest. Finally, what I propose would have to fit in with EEC regulations. This could require hard political bargaining because the barriers to hostile takeover in all other EEC countries are structural and cultural rather than legislative in origin. Superficially Britain could seem to be asking for privilege, but realistically it would only be asking for partial de facto equality.

Recommendation 1

The Government should adopt the suggested fundamental criteria for evaluating takeovers and mergers of:-

- **i) achieving optimal long term efficiency in the use of corporate assets; and**
- **ii) considering on public interest grounds (long-term national efficiency) the protection of selected strategic firms.**

Recommendation 2

The Government should require the OFT to consider referring foreign bids or agreed mergers with foreign companies for strategic firms to the MMC whenever public interest grounds as defined in Recommendation 1 may arise.

ii) General Rejection of Protectionism

In industries which serve highly competitive markets there are generally strong enough pressures to promote corporate efficiency, and these industries have generally escaped the takeover wave in Britain. The Government should accordingly always be vigilant to promote the maximum competition in business. This will generally provide a superior and continuous discipline to the blunt threat of occasional hostile takeover.

Three categories of firms have been the most prominent targets for hostile takeovers. In the first category are firms in mature industries with high cash flows and unsuccessful diversifications. They have been the main firms concerned. There is no doubt that the public interest has generally been served by subjecting such firms to the takeover discipline. This is less likely to be the case for the other two categories. These are firms with long research or development lead times and those of strategic interest (these latter two categories often overlap).

The acceptance and application of my recommended fundamental criteria should permit justified discrimination in the consideration of the desirability of takeovers and mergers in the different cases, but let me repeat one fundamental point. There can be no general case for management protection even when responding to justified concerns over the detrimental effects of certain takeovers. There should *always* be proper pressures on management to perform efficiently and justified concern over particular takeovers cannot justify a general prohibition. Accordingly I reject the *measures* put forward by the protectionist school and in particular the many bid-proofing devices common in Continental Western Europe and Japan. Such measures make no distinction between worthy and unworthy cases. The adoption of these devices would remove the one powerful sanction for efficiency which exists in many industries which are not kept fully efficient by competition in their product markets. It would give Britain the worst of all

worlds, the removal of often the only powerful pressure for management efficiency without the substitute of the superior methods for achieving efficiency present in most of our main economic rivals. The protectionist school has produced some good arguments for change, but I believe the measures I advocate will better meet their legitimate concerns.

Recommendation 3

The Government should:-

- **i) reject the extension of bid-proofing protective devices designed to defend firms against takeovers; and**
- **ii) review case by case the justification for continuing existing protective devices of its own making (e.g. golden shares) and should in future restrict such devices to those which conform with Recommendations 1 and 2.**

Recommendation 4

The Government should continue to promote vigorously by every means the extension of competition in markets for products and services.

iii) Improving the Effectiveness of the DTI, OFT and MMC

In recent years, under a rather rapid succession of Secretaries of State, the DTI has somewhat lost its way. It has largely shed its former unsatisfactory interventionist role and switched to the general promotion of competition and enterprise, a welcome and desirable change. It has been less happy, however, in the discharge of its still sizeable residual role of regulating competition, and particularly takeovers. In the former cases its approach to competition seems not infrequently to have been rejected by other major departments which have succumbed to special pleading (e.g. the Department of Energy

over gas and electricity privatisation where major opportunities to introduce competition were neglected, the Scottish Office over the case for continuing the Ravenscraig Steelworks, the form of privatising British Telecom with but minimum competition, etc.). The Whitehall system makes it quite difficult for the Departments responsible for general competitive economic or environmental policies to influence the specific Departments responsible for industries or regions, hence the frequently observable contradictions in Government policy.

In the case of regulating takeovers, the DTI has been widely if not always fairly criticised over inconsistency particularly as regards the grounds for takeover referrals to the MMC. (The OFT recommends to the Secretary of State whether a referral should take place and he decides). The adoption of Recommendations 1 and 2 should largely overcome these difficulties, including the difficulty discussed in Section 4. c). The fact that the OFT cannot recommend referrals to the MMC solely on public interest ground is an unjustifiable anomaly. Similarly the adoption of Recommendations 3 and 4, which are anyway close to the heart of the modern DTI, should strengthen its reputation, providing its remit runs over that of other powerful Departments in the promotion of maximum competition.

There are, however, some other specific matters which deserve mention. First, given the growth in the amount and complexity of takeover and merger activity, the OFT and MMC need additional resources and personnel to be able to discharge their duties efficiently. In particular they well deserve higher pay all round, most notably for the part-time Commissioners, plus some extra Commissioners with direct senior experience of the largest and most complex bids and mergers.

Second, the DTI should reconsider the form of its hearings. At present the two sides in a contested bid never see the other party's submissions or answers to questions, still less do they get the chance to cross-examine testimony. Given the

complexity of issues this is very unsatisfactory and I believe in large part explains the MMC's difficulties in coming convincingly to grips with the more important and complex issues that arise. The MMC Chairman has described its hearings as an 'economic arbitration', but unlike normal arbitrations the two sides never meet. They can never know what arguments from the other side convinced the Panel and hence never get the chance to attempt refutations which could well have succeeded. For so important a process to flout the rules of natural justice and indeed commonsense, is unacceptable.

Recommendation 5

The Government should review the terms of reference for the OFT and MMC and the adequacy of their resources for the major tasks they are required to discharge.

Recommendation 6

The Government should review the consistency of application of the DTI's general policies of competition and efficiency by other Government Departments.

Recommendation 7

The DTI should alter the form of MMC hearings to that of the civil courts and business arbitrations where each side gives its evidence in the presence of the other and is subject to cross-examination.

iv) Restricting Bids by Certain Bid-Proof Companies

Many commentators, including the CBI, have urged the banning of all or most bids by bid-proof companies on the grounds that they are not subject to the discipline of the threat of hostile takeovers, and have the ability to operate protected from competition. I have rejected such arguments as too

sweeping and capable of serious abuse. There is no justifiable general case for restricting bids by bid-proof companies as such. Nearly all major Japanese and European companies are effectively bid-proof as are a third of British companies (measured by market capitalisation). They include many of the most dynamic and efficient companies in the world, some of whom have performed excellently in Britain to the clear national advantage. To deny hostile bids by all bid-proof companies would effectively ban bids by most foreign companies except those from the United States and certain other English speaking countries with a similar dominant stock exchange system for providing long term capital. It would deny Britain much efficiency and desirable innovation.

There is, however, a category of bid-proof companies, both domestic and foreign, whose effect on national corporate efficiency may be perverse. These are bid-proof companies not operating predominantly in competitive markets and particularly those engaged in protective or monopolistic operations. Such companies have the *possibility* of operating inefficiently for long periods, without external pressure. (An example would be if one of the major privatised monopolies or semi-monopolies - perhaps protected by a golden share - diversified into quite unrelated activities, where shareholders would have no easy redress for poor performance). If bids by such companies were scrutinised under the fundamental criteria of Recommendation 1 then bids from such companies could be referred for MMC examination to see if they might operate against the public interest. By applying this to all such companies regardless of nationality no accusation of bias against foreigners could fairly be made.

Recommendation 8

The OFT should be required to examine all bids by companies with a market capitalisation in excess of (say) £1 billion where there is prima facie evidence that they are bid-proof and either predominantly engaged in monopolistic

operations or operating inefficiently. If any danger exists that such a bidder could operate the acquired company inefficiently in the long term the OFT should refer the case to the MMC for examination under the criteria of Recommendation 1.

v) Reducing the 30% Level for Compulsory Bidding

Rule 9 of the Takeover Panel's City Code governing the conduct of takeovers requires a company whose stake in another company rises above 30% to bid for the whole company. The justification for so high a level is deservedly coming under serious criticism. It permits a minority shareholder holding 25% to 29.99% of the shares to defeat 'Special Resolutions' of the board of a company thus hampering the board in its running of the company. This could easily be to the detriment of the majority of shareholders. It could permit long term abuse of minority power since unless there are one or more other dominant shareholders, a 25% to 29.99% holding constitutes effective control Further a potential bidder can build up a stake of 15% or so and destabilise a company for long periods as other shareholders are left in doubt whether or not a serious bid is in prospect. This too is inherently undesirable.

These two weaknesses would be overcome if the bid threshold were to be lowered to well below 25%. I would favour 15% but a case could be made for a slightly higher figure.

Recommendation 9

The Takeover Panel in conjunction with the DTI and CBI should review the present 30% compulsory bid level rule to reduce it to well below 25% and preferably to below 20%.

vi) Modest Accounting Reforms

The rules and practices of accounting are not responsible for short-termism but two modest and sensible accounting reforms (see Section 4. g) could alleviate some of the pressure for it. First, the profits of fund managers need to be measured in management and financial accounts solely on an annual basis. The sale during a hostile bid of a share held for many years could not credit a fund manager with a large windfall profit that may have accumulated over many years thus falsely bolstering his apparent current year's investment profit.

Second, an annual *audited* figure of 'investment per share' (IPS) should be published by companies annually to include research and development, training and marketing, etc. as well as capital investment. This measure could be adopted by companies now but it is desirable that all companies should do it and backdate it five years.

Recommendation 10

Financial institutions should adopt in their financial and management accounts for fund managers an annual system of accounting for profits and losses in the interests of increasing realism and to eliminate a misleading and artificial contribution to short-termism.

Recommendation 11

All quoted companies should be required to publish annual audited figures of 'investment per share' broadly and sensibly defined by the Accounting Institutes and preferably backdated five years.

c) Further More Fundamental Proposed Remedies

The recommendations I have made so far are, I believe, important contributions to regulating and improving takeovers

and mergers in Britain. They may represent most of what can sensibly and desirably be achieved with the retention of our present system of corporate governance. But if really major improvements are sought, then more far reaching proposals are required. The harsh truth is that the corporate sectors of Japan, Continental Western Europe and of many newly industrialising countries (NICs) are outperforming us and the already worrying gap in performance may widen. If that process is to be reversed we need to address the fundamental causes of Britain's relative corporate malaise. To do this requires above all that we address the fundamental flaws in corporate governance and the aspects of short-termism amenable to remedies.

The overriding requirement is surely to move as far towards owner-capitalism as possible since it is this form of capitalism which largely explains the superior performance of most of our non-English speaking foreign rivals.

i) **The Case for Radically Improving the Rewards of Directors**

The frustrated ambitions of so many of the best of our managers and the marked improvement in performance observable in the majority of management buy-outs and buy-ins (respectively MBOs and MBIs) together point in the right direction. If we want our managers to perform to their best capability (and nearly everyone in the takeover debate will concede that this would greatly reduce the occasions for hostile takeovers) then they must be given the appropriate incentives. This means a radical improvement in *profit-related* performance.

In making this recommendation I do not wish to prescribe in detail how this should best be done; that is a subject which deserves the attention of our best business brains. Rather I would like to commend what I consider to be the relevant principles. First, I believe we need to transform the prospects of rewards

for directors. If that is accomplished they will have sufficient incentive to make comparable reforms for both their managers and staff. Failure to do so would gravely impair their own fortunes and future.

Second, I believe directors should not be offered riskless one-way options as happens with existing share options. If they are to be offered the prospect of very major rewards (say 10% of the improved market capitalisation of their companies in real terms) then they must take an appropriate risk. The level of risk which venture capitalists find sufficient to ensure the best efforts of managers is the investment of one to two years' salary*. I suggest that special stock options on a very much more generous scale than at present should be purchaseable for such amounts, and such investments should be forfeit for failure to perform over say 5 to 7 years. This would compel the most sober assessment before taking up stock options, for it would not be something any but the most competent and experienced would undertake lightly. Once the process was established it would be self selecting since no team of directors would want any passengers. Accordingly I would expect it to lead to many directors returning to smaller companies more suited to their real level of competence, and to capable and usually younger people being promoted or recruited. Properly applied, it could do marvels for corporate performance in the main quoted companies, as has already occurred in the majority of MBOs and MBIs.

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* I do not favour directors taking excessive risks which may distort their judgement, behaviour and decisions to the detriment of efficiency and corporate health. One such example may be that of Canada's largest conglomerate, Hees International Bancorp Inc. where executives have borrowed large sums in relation to their income and wealth to buy shares in their company. The share price has fallen causing executives to be under serious financial strain. See Reference 13.

Third, I believe the same kind of radical changes in risks and rewards should also be offered to non-executive directors, adjusted for the time they give to companies. The really capable non-executive directors would be in high demand, for the right reason, namely the contribution they could make to major profitable growth. They could be expected to perform with real zeal the functions they are supposed to be exercising fully now but largely lack the power and incentive so to do. They could confidently be expected to make life difficult for any underperforming chairmen and chief executives, and they could expect the backing of their executive colleagues whose own fortunes and futures would be at stake. Life on boards would become very different from what exists at present. It would be often difficult, insecure and uncomfortable but there would be the opportunity for very large rewards when truly earned. The gain for shareholders should be equally welcome.

Recommendation 12

Non-executive directors of quoted companies, in partnership with their chairmen and chief executives, should draw up radically improved performance-based share incentive proposals. These proposals would require directors to invest substantial sums (say one to two years' current earnings), at risk of forfeit for non-performance, to participate in new schemes. The proposals should be considered at extraordinary general meetings of the companies' shareholders within say 6-12 months of proposals being put.

Recommendation 13

The investment institution, the CBI, the Institute of Directors and any other relevant bodies should commission early professional studies of radically improved performance-based incentive packages for all directors, involving the risk of

substantial sums (say one to two years' current salary) for director participation, to help to prepare shareholders for judging proposals coming forward from the implementation of Recommendation 12.

ii) Improving the Effectiveness of Shareholders

I believe that the radical improvement of directors' performance-related rewards will do much to improve corporate performance and thereby reduce the likelihood of hostile takeovers or cosy agreed takeovers or mergers. But I also believe it desirable and necessary to improve the effectiveness of shareholders. This, after all, largely explains the consistent and long term superior performance of American firms such as Berkshire-Hathaway (see Section 5. d) and of our main non-English speaking foreign rivals. All these entities have made owner-capitalism an effective reality. However much one improves the incentives of directors (and those below them) truly effective performance also requires the knowledge and involvement of effective long-term owners. This substitutes regular, continuous, knowledgeable discipline in place of the blunt, occasional and often random discipline of the hostile takeover. It is also a sure preventative of cosy mergers and agreed takeovers.

The question is how can Britain achieve this much to be desired form of owner capitalism? We cannot just ask the major banks and investment institutions to behave the way their Japanese and European counterparts do. Patently, as presently staffed and organised, they could not do the job. But if agreement could exist on the advantages of the Japanese-Continental system, the banks and investment institutions, with help from the CBI, IOD, etc. could begin a major reappraisal of their roles.

One desirable change would be to concentrate shareholdings in the hands of only a few institutions

per company, say three to five, and to ensure each investment institution was expertly informed about the fewer companies in which it would invest. This of itself would do much to make them much longer-term shareholders, for there would be less likelihood of trading in and out of shares as is done today because they will on average get better performance by staying with the much better managed companies they know. It will be urged that this is a riskier policy for the institutions since they would lack the present wide spread of investments. The only answer to that is to point to the Berkshire-Hathaways of this world who far outperform the investment institutions, few of whom beat the index of average share performance.

A similar and equally important plea for radical change should be made to the major clearing banks. They should be urged to become providers of long-term debt finance to their client companies *and* to take major equity stakes. It would mean raising large sums of new debt and equity capital themselves and recruiting and training expert staff to manage corporate client relationships. The rewards for this approach (which should command a widespread welcome from business) should lead to major profit opportunities for those banks which move quickly on well prepared plans. And if British banks are slow to make these responses then British companies should actively seek an exclusive arrangement with Japanese and Continental Banks, or any American banks prepared to offer the right relationship. The issue is too important to leave in the hands of British banks if they are unresponsive. Probably the best way for British Banks to move forward would be to have Continental and Japanese banks as minority partners

in joint ventures to secure the benefit of their experience.

The implementation of this radical change in bank-company relationships would provide two major benefits. First, it would add very significantly to ownership stability by encouraging long term ownership. Second, because the banks would be so much more knowledgeable about client companies, and able to discipline and replace inefficient management, they would run far less risk than at present and could sensibly lend a much higher proportion of debt at lower cost than at present. This would reduce and eventually eliminate the higher cost of long-term finance which presently so disadvantages British firms when undertaking long term development. These are large prizes, but entirely achievable ones.

Recommendation 14

The CBI, IOD and other representative business organisations should commission studies of long-term financing and concentrated expert long-term shareholding in Japan and Continental Europe in order to be able to help British firms to achieve more efficient forms of owner-capitalism.

Recommendation 15

The investment institutions and the CBI, IOD, etc. should commission studies of how best to reorganise institutional shareholdings to a form with greater concentration of shareholdings and greater knowledge of companies leading to longer term and more profitable ownership to the benefit of the companies and their own investors.

Recommendation 16

The major clearing banks should commission studies of the Japanese and Continental banking relationships with

business to determine how best to move closer to their successful examples.

iii) The Case for a Takeover Moratorium

The two fundamental radical proposals just outlined would take several years to implement even if widely supported. In that period hostile takeover activity could well increase as many would-be predators, British and foreign, took advantage of what would probably be their last chance for major acquisitions. The implemented reforms would thus come too late for too many firms to the potential serious detriment of Britain's long term corporate efficiency. The only way to prevent such an outcome would be for the Government to find the legal means to declare a two or three year moratorium on carefully defined categories of firms by allowing the Office of Fair Trading say a three month period, case by case, to determine whether or not any particular bid should be disallowed in the agreed moratorium period.

The Government should only embark on this course if there was clear evidence from the CBI, IOD etc., the main investment institutions and the clearing banks that they accepted Recommendations 12 to 16 and were prepared to implement them urgently. The Government would also probably need to agree the legality of a moratorium with our EEC partners. It would give British business the necessary period to make the desirable long-term changes. By strengthening corporate efficiency and hence Britain's economic growth rate, we would become a more valuable EEC trading partner. This ought to help to secure EEC agreement to the two or three year moratorium.

Recommendation 17

The Government should arrange a two or three year legal moratorium of carefully selected categories of hostile takeovers, providing it receives sufficient assurances from the representative business institutions (CBI, IOD, etc.), investment institutions and banks that they support and intend to implement Recommendations 12 to 16.

d) Conclusions

In this paper I have tried to investigate the main underlying causes of the widespread concerns arising from the marked level of hostile takeover activity in Britain. In particular I have set out the serious flaws in corporate governance in Britain which constitutes the heart of the problem and which if altered sensibly holds the key to progress. It is clear that the present position leaves much to be desired. Accordingly, in the light of my analysis of causes and concerns I have examined the main proposed remedies and identified the most promising ones, adding major suggestions of my own. I have enshrined my views in seventeen specific recommendations designed to ensure corporate efficiency, to safeguard shareholders' interests and to provide managements with all the necessary disciplines and incentives for superior performance. If implemented, I believe Britain could largely reverse the widening gap between our corporate performance and those of Japan, Continental Western Europe and the newly industrialising countries.

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