Director Neutrality - An Obstacle in the Path of EU Takeover Harmonisation

by Brian McCall and David Schulman

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Director neutrality

An obstacle in the path of EU takeover harmonisation

US experience shows that activist Boards of Directors can and do have an invaluable role to play in protecting and furthering shareholder economic interests. Brian M. McCALL and David E. SCHULMAN argue that the antipathy of the High Level Group of Company Law Experts towards the ability of Boards to adopt reasonable defensive measures is based on a number of oversimplified and, in certain cases, erroneous premises.

A new chapter has been written in the search for a uniform approach to takeovers in the EU. In July 2001, the European Parliament rejected the proposed Takeover Directive after 12 years of negotiation (see www.practicallaw.com/a19568) (see also box “Timeline: EU Takeover Directive”). The Commission subsequently established the High Level Group of Company Law Experts (the Group) to assist it in preparing a revised directive (see www.practicallaw.com/a20317). On 10th January, 2002, the Group published its Report on Issues Related to Takeover Bids (the Report).

The Report as a whole lauds the benefits of takeovers. One of its recommendations, however, designed to encourage increased takeover activity in the EU, appears to have the practical
effect of sacrificing share price maximisation. The Report recommends that directors be prohibited from taking any actions that would frustrate a takeover bid unless they have specific shareholder approval at the time of the contemplated action. For a number of reasons, imposing Board of Director takeover defence neutrality would be to the detriment of shareholder value. In order to understand why, it is necessary to consider:

- The general premises that lead to the prohibition on any defensive measures by the Board of Directors of a target company without contemporaneous shareholder approval.
- The Report’s analysis of the use of defensive measures in US capital markets.
- The proposed exception to the takeover neutrality rule.

**GENERAL PREMISES**

The Report identifies three principal benefits of takeovers in the EU (Report, 19):

- Takeovers are a means for acquirers to create wealth by exploiting synergies and creating efficiencies of scale (the Efficiency Goal).
- Takeovers offer shareholders an opportunity to obtain share prices in excess of market trading prices (the Share Price Maximisation Goal).
- Takeovers offer a means of disciplining management of public companies (where managerial control is generally divorced from overall equity ownership) and reallocating under-utilised assets (the Management Discipline Goal).

The Report specifies how a Board of Directors should respond to a takeover proposal made to its shareholders: the Board may “frustrate” a potential bid and erect takeover defences only when shareholders have affirmatively approved such action following the announcement of the specific takeover bid (Report, 28).

Significantly, however, the Report does not address how the three benefits identified above can come into conflict and, more precisely, how the Efficiency Goal and the Management Discipline Goal can detract from the Share Price Maximisation Goal when Board of Director takeover defence neutrality is imposed. Three particular lines of argument put forward in the Report are open to criticism:

- Its uncritical euphoria for business combinations.
- Its assertion that shareholders, to the exclusion of directors, are best equipped to select economically sound offers.
- Its view that managers are generally faced with a conflict of interest when a takeover bid is made.

**M&A euphoria**

In support of the Efficiency Goal, the Report takes the view that takeovers in and of themselves are desirable and necessary if the EU is to reap the benefits of a single market. It argues that takeovers are a way for “bidders to create wealth by exploiting synergies between their existing business and the target company. Many European companies will need to grow to an optimal scale to make effective use of the integrating internal market. The same is true for companies which compete on global markets. Takeover bids are a means to achieve this for those engaged in the business of both bidder and target” (Report, 19).

This uncritical euphoria for business combinations leads the Group to recommend regulation, which, absent competition law issues, promotes the success of any takeover in and of itself. However, while takeovers are generally beneficial to an efficient market economy and have helped spur the competitiveness of the US economy in the past 20 years, there is, as with everything, the possibility of “too much of a good thing.”

Much economic research has indicated that the perceived value, both to companies and on a macro-economic level to an economy, may be overstated. Two studies by KPMG in 1999 and 2001 demonstrated that mergers and acquisitions created shareholder value in only 17% and 30% respectively, of the transactions studied, and actually destroyed shareholder value 53% and 31% of the time respectively (KPMG Transaction Services, “World Class Transactions: insights into creating shareholder value through mergers & acquisitions” (2001) and “Unlocking Shareholder Value: the keys to success (1999)). Interestingly, the 2001 study showed that European firms were less generally beneficial than American companies in

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**The High Level Group of Company Law Experts**


In addition to its comments on the use of defensive measures by directors (see main text), the Report makes recommendations on the following three main areas of concern:

- How to ensure the existence of a level playing field in the EU regarding the equal treatment of shareholders across all member states.
- The definition of “equitable price” to be paid to minority shareholders.
- A majority shareholder’s right to buy out minority shareholders (“squeeze out” procedure).
creating value, in that only 24% of European companies created value as opposed to 35% for American companies (see also Alan Alpert, “The Fundamental Things” The Daily Deal, 18th October, 2001).

In many respects, the premises underlying the Report bear a striking resemblance to the “efficient market theory” which has been advocated by some academics in the US but which has been debunked by economists and rejected by US (and particularly Delaware) courts as not reflective of current capital market conditions (Martin Lipton & Paul K. Rowe, “Pills, Polls and Professors: A Reply to Professor Gilson”, New York University Center for Law and Business, Working Paper #CLB-01-006, (2001) (NYU Paper) and M O’Sullivan, Contests for Corporate Control (Oxford University Press 2000)). For example, “the opponents of the efficient market theory pointed out that corporations were not chartered by the states solely to maximise shareholders’ short-term gains” (NYU Paper, 11-12). The Report itself acknowledges these broader macroeconomic objectives (Report, 19).

In addition, “large corporations could not function in an environment where they were for sale whenever their market cap dipped below the break-up value of their assets. Tender offers are not the functional equivalents of free votes, since the decision not to tender (whether into an all-cash or all-shares offer or a two-tier, front-end-loaded offer) carries with it economic risks and detriments; not knowing whether the mass of other shareholders will tender or not, the individual holder faces the classic prisoners’ dilemma and is effectively stumped into tendering. The opponents also observed that many hostile bids were opportunistic attempts to buy assets on the cheap and there was no empirical evidence that such takeovers were always (or ever) good for the economy” (NYU Paper, 11-12. See also W. Allen, “Ambiguity in Corporation Law”, 22 Del. J. Corp.L. 894, 896-897 and J. Charkham, “Keeping Good Company: A Study of Corporate Governance in Five Countries”, 219 (1994) at 229).

**Timeline: EU Takeover Directive**

<table>
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<th>Date</th>
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<tr>
<td>10th September, 1990</td>
<td>Amended proposal presented</td>
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<tr>
<td>June, 1991</td>
<td>Negotiations on proposal suspended</td>
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<tr>
<td>7th February, 1996</td>
<td>Commission presents streamlined proposal</td>
</tr>
<tr>
<td>11th July, 1996</td>
<td>The Economic and Social Committee endorse the second proposal</td>
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<tr>
<td>21st May, 1997</td>
<td>The Legal Affairs Committee approves limited harmonisation of the rules on takeover bids</td>
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<tr>
<td>10th November, 1997</td>
<td>Commission produces amended proposal incorporating most amendments adopted by EP at first reading</td>
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<tr>
<td>19th June, 2000</td>
<td>Council of Ministers reaches common position on proposal, incorporating just over half of the EP’s amendments</td>
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<tr>
<td>26th July, 2000</td>
<td>Commission accepts Council’s common position</td>
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<tr>
<td>13th December, 2000</td>
<td>EP vote at second reading. EP adopts amendments to the Council’s common position</td>
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<tr>
<td>12th February, 2001</td>
<td>Commission’s opinion on EP’s amendments to Council common position. Commission accepts some of EP’s amendments but rejects others</td>
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<tr>
<td>6th June, 2001</td>
<td>Coniliation committee/procedure outcome. Coniliation Committee (comprising representatives from the Council of Ministers and the EP) reaches agreement on a compromise proposal</td>
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<tr>
<td>10th January, 2002</td>
<td>High Level Group of Company Law Experts produces its Report on Issues Related to Takeover Bids</td>
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**Shareholders as decision makers**

In support of the Share Price Maximisation Goal, the Report states that takeover bids give shareholders “the opportunity to sell their shares to bidders who are willing to offer a price above the prevailing market price” (Report, 19). Whether or not
intended, this statement ignores the question of which of the following is preferable:

- A premium over a specific market price at a certain point in time; or
- The highest price reasonably obtainable from actual and potential bidders.

A premium to an all time low share price may not necessarily be related to the intrinsic value of the business due to cyclical or general industry or market conditions (see for example, “Cash rich loss makers look ripe for takeover predators”, Financial Times, 3rd September, 2001, which explains how many technology companies were trading at a market capitalisation even less than the cash on their balance sheet). Would shareholders of a manufacturing company have benefited in 1999-2000 in taking shares of an internet company whose value metrics (but not price/earnings ratio since these companies had no earnings) at that time were at a substantial premium to the manufacturing company’s share trading price?

The Report assumes that shareholders will behave efficiently and rationally and choose wealth-creating bids without the need for independent Board intervention. It states that in a takeover bid, the shareholders must make the ultimate decision, arguing that the securities markets, and as a result, “the capacity of European industry to finance itself, will only develop fully where this principle is generally adhered to … It is not for the Board of a company to decide whether a takeover bid for the shares in the company should be successful or not” (Report, 20). While shareholders generally should be entitled to make the final investment decision, they may not always be positioned and equipped to respond to a takeover offer and maximise its benefits for all shareholders concerned.

Information. For an EU company required only to produce annual or semi-annual accounts, the information available to shareholders may be over a year out of date. Shareholders may therefore lack effective informa-
tion to negotiate a better offer. In addition, shareholders (and this is particularly true for a company with a widely dispersed shareholder base) may not have the incentive (personal or financial) to invest the resources to analyse properly a proposal and attempt to obtain a better price.

The risks of value-reducing acquisitions would appear to be higher in the takeover of a public company (particularly when the target management opposes the acquisition) where access to full information about the target and its financial and operational performance is generally much more limited. This restriction is particularly true for most EU companies when compared to US public companies, whose publicly disclosed information is generally more extensive and timely than EU companies. (The reasons for greater information on US companies are regulatory and market driven. For example, US public companies are required to disclose quarterly financial statements together with MD&A analysis and period-on-period comparison as opposed to more limited financial reporting on an annual or semi-annual basis for EU companies. The more active and aggressive analyst and media coverage in the US as compared to the EU also provides extensive information and analysis, including forecasts and projections, to the market.)

As a result, the bidder is forced to evaluate the likelihood of synergies and opportunities for value creation without access to complete information (especially in a hostile takeover). Since many takeovers may not be successful in the longer-run, there is a role for an informed Board of Directors to play in assessing, improving and occasionally rejecting takeover proposals involving share-for-share exchanges as well as all-cash consideration.

Advantages of activist Board. The Report also ignores the benefits that an activist Board of Directors may play in the pursuit of the Share Price Maximisation Goal. Generally, the Board of Directors, who possess extensive, detailed information about the company and its plans will be better positioned than shareholders to assess the merits of a specific offer and, under the pressure of an aggressive timetable, to use this information to obtain the best price and terms. And, as the Report acknowledges, “the board has the explicit authority to seek alternative bids” (Report, 27).

Without the ability to delay the timetable of an offer by using defensive measures, this explicit authority may be meaningless, given the time needed to engage an investment banker, conduct a full auction, permit due diligence and negotiate terms.

Research has also indicated that in the US capital markets where directors have greater discretion to adopt takeover defences than their European counterparts, the practical effect has been to increase shareholder value, not reduce it:

- Another study conducted on transactions between 1992 and 1996 demonstrated that premiums paid to acquire target companies with poison pills were on average 8% higher than premiums paid for target companies that did not have poison pills (“Mergers and Acquisitions, Poison Pills and Shareholder Value: 1992-1996”, Georgeson Shareholder Communications Inc., 1997). The study shows that takeover defences added an additional US$13 billion in value during the period studied, that the shareholders of acquired companies without poison pills gave up US$14.5 billion in potential value, and concludes that poison pill plans did not reduce the likelihood of the making or successful outcome of a friendly or a hostile bid. Companies with takeover defence plans had a slightly higher takeover rate than companies without such a plan.

Thus, in the US, takeover defences have actually increased public takeover activity and enlarged shareholder value by increasing premiums paid to shareholders. This practical experience underscores the general point that shareholders are not necessarily the most efficient group to review takeover offers, due to apathy, competing investments and other interests, and free rider problems. The Report itself acknowledges the reality of general shareholder inertia when it states that “some structures… have arguably been developed to protect a company with dispersed ownership against a small minority dominating the general meeting in the usual absence of the vast majority of shareholders” (Report, 24).

Curiously, the Report undercuts its own support for shareholder freedom of choice when it recommends that agreements freely entered into by shareholders that voluntarily restrict the shareholder’s ability to accept takeover offers (standstill agreements) should be declared by the state to be unenforceable. It states that “shareholders entering into such an agreement lack sufficient information to judge whether tendering their shares in a potential future bid would be attractive or not” (Report, 38, emphasis added). The apparent rationale is that shareholders may only enter into standstill arrangements after, but not before, the particular announced bids have arisen. It must be asked: why forbid more knowledgeable directors from protecting shareholders (who may lack sufficient information to judge) from coercive or unfair bids but nevertheless protect these same shareholders (who lack sufficient information about a future takeover) from entering into standstill agreements?

Finally, the Report ignores that fact that certain financial engineers (“bust-up” buyers) look to take
short term economic benefit for themselves at the expense of shareholders realising long term value. “The goal of such bids [hostile bids of the 1980s in the US] was not to improve the management of the target’s assets or to reap synergies from an existing rival but to bust up the corporation and sell the pieces for a quick profit. The bidders were often seeking quick returns, not improved enterprises” (NYU Paper, 18). This description highlights the conflict between the Share Price Maximisation Goal and the Management Discipline Goal.

The conflicted Board
One of the reasons the Report gives for imposing takeover defence neutrality on the Board of Directors is that “managers are faced with a significant conflict of interest if a takeover bid is made. Often their own performance and plans are brought into question and their own jobs are in jeopardy. Their interest is in saving their jobs and reputation instead of maximising the value of the company for shareholders” (Report, 21).

There are several reasons why this view is misguided:

• The NYU Paper found that the view that directors were only capable of acting in their self-interest was unsupported by empirical evidence (NYU Paper, 12).

• Justifying a blanket rule of takeover defence neutrality on the basis of concern over self-interest betrays an oversimplified and incomplete view of the reasons for takeovers. This approach addresses only one scenario, the under-performing mismanaged company. While, admittedly, this may be one reason for launching a bid, there are numerous reasons for doing so that do not call into question the performance of management and do not threaten their jobs. In certain instances, the target may be performing so well that it will add value to the bidder’s business.

• Any country with a developed corporate law of directors’ fiduciary duties possesses principles to address conflicts of interest that will inevitably arise in corporate transactions:

- in general, the response of developed corporate law is not to prohibit the Board from acting in any way, but to require full disclosure of the conflict and in certain cases to require independent members of the Board to take decisions (see for example, Section 144, Delaware General Corporation Law).

- in situations where it is shown that self-interest is the motivating reason behind directors erecting barriers to specific bids, corporate law should permit shareholders to have a remedy against the directors.

Why therefore handcuff directors from taking prudent action merely because of a theoretical possibility of a conflict in some circumstances?

The risk of liability of a director to shareholders for a lost premium when he acted merely to protect his own personal interests should serve as a sufficient legal check to regulate his behaviour.

It would be reasonable to propose that an independent committee comprised of non-executive directors (those not dependent on a salary from the company for their livelihood) be empowered to adopt takeover defences. This committee could be required to take independent advice from a financial adviser.

In short, there are considerable possibilities for protecting shareholders against actual conflicts of interests, although many do involve more complexity and subtlety than a blunt straightforward prohibition of any action. If corporate law, and in particular the law of directors’ fiduciary duties, needs some refinement and standardisation among EU member states, the solution is to address this law and make it more robust. If the Group is correct that fiduciary duty law is insufficient protection in the context of the adoption of takeover defences, then it must be insufficient in the context of other conflicts (which occur more frequently than takeovers).

US TAKEOVERS

One point the Report does state accurately is that its proposals are inconsistent with the laws governing takeovers in the US, the most active capital market in the world (Report, 39). The Report attempts to justify the EU rejecting the legal framework developed in the US over the past 20 years with a number of reasons, including the fact that:

• There is no harmonisation in the US.

• US Boards have many checks on their performance.

Harmonisation

The Report claims that harmonisation with US takeover law is illusory as no one set of takeover rules is generally applicable in the US. “Company law is a matter of state law in the United States and the laws of the various states regulating takeover bids differ widely … As a result, there is no clear level playing field for takeover bids within the United States” (Report, 40).

This statement is inaccurate in what it omits to state. It is certainly true that corporate law is a matter generally reserved to the individual states to regulate. However, this fact is largely irrelevant in the realm of public companies. The majority of US publicly listed companies are incorporated in Delaware and most companies that change their state of incorporation choose Delaware (Demetrios G. Kaouris, “Note Is Delaware Still a Haven for Incorporation?”, 20 Del. J. Corp. L. 965 (1995) at 966. The Secretary of State of Delaware claims on its website that “more than 308,000 companies are incorporated in Delaware including 60% of the Fortune 500 and 50% of the companies listed on the New York Stock Exchange” (see www.state.de.us/corp/index.htm)).
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In addition, due to the pre-eminence and developed nature of Delaware law, other states tend to base their statutes and judicial decisions on the law in Delaware, with the result that there is much harmonisation among the states (Rachel B. Rubin, “Comment: Nonprofit Hospital Conversions in Kansas: The Kansas Attorney General Should Regulate All Nonprofit Hospital Sales”, 47 UK-SLR 521 (1999) at n.188). Thus, for all practical purposes, the law of Delaware is the law of public companies and, as a result, of takeover bids.

Beyond this general point, on the issue of the ability of directors to defend against takeover bids, the variation that does exist between Delaware and the rest of the states is not, as the Report implies, that the other states prohibit defences. To the contrary, according to the NYU Paper, no American jurisdiction has gone “further than Delaware and adopted rules, either by statute or judge-made law, that restrict takeover defences more tightly than Delaware. No American jurisdiction has ever adopted a framework for takeover law based on the efficient market theory or gone further than Delaware in that direction” (NYU Paper, 19). As a result, the proposals of the Report will not harmonise with any jurisdiction in the US (even taking account of the fact that corporate law is a matter of individual state regulation).

Checks on performance

The Report claims that the US can afford directors the freedom to defend against bids because in the US, unlike in the EU, there are other means to discipline management (Report, 40-41). Comments on some of the examples listed in the Report are as follows:

• American Boards face pressure to behave from non-executive directors. There is no evidence to suggest that non-executive directors of EU public companies are any less independent and vigilant than their American counterparts.

• There is more transparency of information on US companies. If this is the case, why not adopt the solution that the disclosure rules of the EU be improved so that more timely and more transparent information is required to be publicly disclosed? This reform would have the added benefits of harmonising prospectus and ongoing reporting requirements with those of the US SEC and making cross-border capital markets transactions simpler and more harmonised.

• US directors face the risk of proxy contests to remove directors. Proxy contests aimed at obtaining control of a Board of Directors of a US company are actually quite infrequent and are generally not successful. One study showed that in the period 1981 through 1985, there were just over 40 proxy fights for control as compared to 250 tender offers (John Pound, “Proxy Contests and the Efficiency of Shareholder Oversight”, 20 J.Fin.Econ. 237 (1988) at 237 and 251). Although this study indicated a 53% success rate for dissidents during the period, a later study found a success rate of only about 30% (Randall S. Thomas, “The Impact of Rights Plans on Proxy Contests: Reevaluating Moran v. Household International”, 14 Int’l Rev. L. & Econ. 327 (1994) at 330). So, while in theory shareholders can change control of US Boards (as can shareholders in many EU states), this power is rarely used and is not overwhelmingly successful. As a result, the threat of a proxy contest to remove directors is not generally a regular concern for US Boards.

• Directors face pressure from institutional investors. This may be true in the US but it also appears true in at least part of the EU. For example, in the UK, institutional shareholders appear more capable of exerting influence than in the US where there is no formal industry equivalent of the Association of British Insurers (ABI) in terms of shareholder influence. In the US, institutional shareholders do not have the organisation or influence to enforce practically universal policies such as the annual 5% restriction on the Board’s ability to issue new shares. If this pressure really works, why not encourage procedures for such groups to make their influence known rather than prohibiting all Board takeover defences?

• The US judicial system is better equipped to deal with these issues than EU judicial systems. Again, if this is true, surely the solution is to improve and open up the European judicial system? If directors act in an improper manner feathering their own nests, then let the shareholders have a cause of action against them. The Report admits that the US experience shows that the possibility of such liability is sufficient to keep Boards in line.

• The US system permits an active takeover market. This argument is
confusing, given that the Report acknowledges that despite the “relatively broad discretion of the Board to defend against takeover bids ... takeover activity in the American capital markets is intensive.” (Report, 41). Is this not a reason for allowing the adoption of limited defensive measures? The Report claims, however, that existing law in the EU has the effect of making contests for control impossible to win. It does not identify these impenetrable barriers. Presumably, they refer to governments’ golden shares and extensive corporate cross ownership. Perhaps the solution is to identify and address the various existing barriers to takeovers and not prohibit the takeover defences employed in the US, which the Report itself acknowledges do not stifle general takeover activity.

- Americans need defences because they do not have a mandatory bid provision. The Report argues that takeover defences in the US are prompted by the ability of bidders to make partial offers for US companies, in effect either to purchase only a majority of the shares (and hence control) and not the remainder, or to acquire the majority in a bid at one price and later acquire the balance at a less attractive price. It argues that such practices are prohibited by the proposal, already in place in many EU countries, that shareholders who acquire control are required to offer to buy all shares from the remaining shareholders.

However, first, provisions of both US federal securities law and state corporate law contain numerous provisions discouraging or restricting such practices as two-tier, frontend loaded tender offers and, as a result, such structures have become rather infrequent (see Rule 13e-3 under the Securities Exchange Act of 1934, Section 203, Delaware General Corporation Law and Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del.Supr.,1970) (holding that the concept of fairness is the proper test to determine the duty of a parent corporation to its subsidiary in business dealings); Trans World Airlines, Inc. v. Summa Corp., 374 A.2d 5 (Del.Ch.,1977) (holding that the intrinsic fairness test is to be applied in situations in which a fiduciary duty existing between a parent and dominated subsidiary is accompanied by self-dealing)).

Second, the economic and other pressures on shareholders to accept a bid (that is, the prisoners’ dilemma) exist in two-tiered offers as well as in all-cash, all-holders offers (see above “Shareholders as decision makers”). The mandatory bid provisions as in force in the EU now, or as proposed in the Report, do not remove the coercion to tender as it is not certain that the bidder will offer the same consideration in the mandatory bid as in the prior bid. Even the Group’s proposal to harmonise existing law, although favouring a presumption towards the highest price previously paid, allows for exceptions. In addition, given the time value of money, if shareholders fear that enough other shareholders will tender in the first offer, then they will not want to be forced to wait through the delay until the mandatory bid is launched and closed to receive their money and, as a result, will be pressured to tender in the hostile coercive bid. The EU mandatory bid provision does not, therefore, eliminate the pressure on shareholders to tender into an unfair bid.

- Even Americans debate the advisability of takeover defences. Although the Report is correct that certain academics and economists criticise the balance that the US legal system has evolved between the freedom to contest a bid and protecting shareholders against Boards who are protecting their own jobs, this critique has remained by and large academic. No state has reversed by statute or judicial decision the policy and rules governing the ability of directors to defend against a takeover bid (see above). No state, be it Delaware or any other, has adopted a prohibition on defensive techniques bearing any resemblance to the one proposed by the Report.

PROPOSED EXCEPTION

The final paragraph of the section of the Report dealing with takeover defences provides a rather disturbing suggestion. It recommends that if harmonisation with the US is desirable then the EU can consider “whether to provide that the benefits of the application of the principles ... in this report, can only be enjoyed by listed European companies making general takeover bids for other listed European companies” (Report, 42).

Put another way, takeover defences would be permitted where the bidders are non-EU companies (which would be difficult to define). The Report does recognise that this exception to the takeover neutrality rule could only be supported “to the extent that this would not violate international agreements” (Report, 42). In the pursuit of a Share Price Maximisation Goal, it is hard to justify allowing the Board of Directors of an EU company if faced with a bid from a US company and an EU company to adopt takeover defences against the US company but not the EU company.