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European Takeover Law: The Case for a Neutral Approach

By **Luca Enriques**, Consob, University of Bologna, Faculty of Law, and European Corporate Governance Institute (ECGI)

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Summary

This paper argues that in revising the Takeover Bid Directive, EU policymakers should adopt a neutral approach toward takeovers, i.e. enact rules that neither hamper nor promote them. The rationale behind this approach is that takeovers can be both value-creating and value-decreasing and there is no way to tell ex ante whether they are of the former or the latter kind. Unfortunately, takeover rules cannot be crafted so as to hinder all the bad takeovers while at the same time promoting the good ones. Further, contestability of control is not cost-free, because it has a negative impact on managers' and block-holders' incentives to make firm-specific investments of human capital, which in turn affects firm value. It is thus argued that individual companies should be able to decide how contestable their control should be. After showing that the current EC legal framework for takeovers overall hinders takeover activity in the EU, the paper identifies three rationales for a takeover-neutral intervention of the EC in the area of takeover regulation (pre-emption of "takeover-hostile," protectionist national regulations, opt-out rules protecting shareholders vis-à-vis managers' and dominant shareholders' opportunism in takeover contexts, and menu rules helping individual companies define their degree of control contestability) and provides examples of rules that may respond to such rationales.

Keywords: Takeover Bid Directive, Board Neutrality, Mandatory Bid Rule, Market for Corporate Control

JEL Classification: K22, G34, G38

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Address for correspondence:

Luca Enriques
CONSOB
Via G.B. Martini 3
00198 Rome
Italy
Phone: +39 06 84 77 235
E-mail: l.enriques@consob.it

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Fondazione Eni Enrico Mattei
Corso Magenta, 63, 20123 Milano (I), web site: www.feem.it, e-mail: working.papers@feem.it

European Takeover Law: The Case for a Neutral Approach

Luca Enriques (*)

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Abstract

This paper argues that in revising the Takeover Bid Directive, EU policymakers should adopt a neutral approach toward takeovers, i.e. enact rules that neither hamper nor promote them. The rationale behind this approach is that takeovers can be both value-creating and value-decreasing and there is no way to tell ex ante whether they are of the former or the latter kind. Unfortunately, takeover rules cannot be crafted so as to hinder all the bad takeovers while at the same time promoting the good ones. Further, contestability of control is not cost-free, because it has a negative impact on managers' and block-holders' incentives to make firm-specific investments of human capital, which in turn affects firm value. It is thus argued that individual companies should be able to decide how contestable their control should be. After showing that the current EC legal framework for takeovers overall hinders takeover activity in the EU, the paper identifies three rationales for a takeover-neutral intervention of the EC in the area of takeover regulation (pre-emption of "takeover-hostile," protectionist national regulations, opt-out rules protecting shareholders vis-à-vis managers' and dominant shareholders' opportunism in takeover contexts, and menu rules helping individual companies define their degree of control contestability) and provides examples of rules that may respond to such rationales.

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1. Introduction

The Takeover Bid Directive[1] (TBD) contains a revision clause: around May 2011 the European Commission shall "examine this Directive in the light of the experience acquired in applying it and, if necessary, propose its revision. That examination shall include a survey of the control structures and barriers to takeover bids that are not covered by this Directive"[2]. May 2011 is approaching: it cannot be too early to start a debate on the future of European takeover law.

Both before and after the adoption of the TBD, the policy debate on European Takeover law has almost exclusively focused on how contestable European companies should be.[3] Commentators generally agree that "[t]he true main goal of the Takeover Directive [is][] the maximization of takeovers – i.e. the facilitation of as many takeovers as 'the market' desires."[4] If that is true, then the TBD was indeed a spectacular failure, much less for what it did not do (it failed to impose the board neutrality rule and the break-through rule) than for what it positively did. In fact, as section 3 and 4 show, many EC rules hinder takeover activity rather than promoting it. That is because in

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[1] Directive 2004/25/EC on Takeover Bids of 21 April 2004, OJ L 142, 30.4.2004, p. 12–23.
[2] Article 20 TBD.
[3] See e.g. Klaus J. Hopt, *Takeover regulation in Europe -- The battle for the 13th directive on takeovers*, 15 AUST. J. CORP. L. 1 (2002); Vanessa Edwards, *The directive on takeover bids – Not Worth the Paper it's Written on?*, 1 ECFR 416 (2004).
[4] Beate Sjåfjell, *Towards a Sustainable European Company Law* 166 (2009).

general policymakers have a tendency to enact rules that protect incumbent managers or controlling shareholders from the market for corporate control. Such a pro-incumbent approach has so much characterized national takeover laws in the past decades that the starting point for EC intervention in the area was one displaying a number of national anti-takeover measures. It was only natural for the EC to include them in the TBD in its attempt to provide a single EU-wide legal framework for takeovers. By doing so, however, it took national anti-takeover provisions under its wings, thereby extending them to all EU (and EEA) states and petrifying them at least until the review of the TBD[5].

When the time for the review of the TBD comes, the European Commission will predictably try to push for more mandatory rules, such as the ones it failed to impose in 2004, to tilt the current legal framework in the direction of more contestability (I call this possible outcome an "enhanced TBD regime"). It is highly unlikely that a similar attempt will be more successful then: national governments' protectionist instincts have, if anything, strengthened since 2004.

This contribution outlines an alternative regulatory approach to takeovers with specific reference to the EC framework. It argues that EC law should adopt a consciously neutral approach to takeovers, i.e. it should aim neither to make European companies easier to take over nor hinder the functioning of the market for corporate control by making takeovers more costly and therefore more rare. Section 2 articulates this claim based on the hardly contestable proposition that takeovers as such are neither good (value-creating) nor bad (value-destroying): there are good and bad takeovers, but takeover rules cannot be crafted so as to hinder all the bad ones while at the same time

[5] On the petrification effect of EC (company) law see Richard M. Buxbaum and Klaus J. Hopt, *Legal Harmonization and The Business Enterprise* 243 (1988).

promoting all the good ones. After showing that EC rules are overall "takeover-hostile" in Sections 3 and 4, Section 5 illustrates how a takeover-neutral EC legal framework would look like. Section 6 concludes.

2. The economic rationale of a neutral approach

Takeovers, both friendly and hostile, are neither intrinsically good nor intrinsically bad: they may create value or destroy it. Unfortunately, whether a given takeover is value-increasing or value-decreasing is only known for sure after it has gone through.

Takeovers perform two functions: they discipline managers and reallocate control. Let us first consider takeovers as a discipline device. Their positive effects on managerial agency costs are impossible to quantify, if only because it is the mere possibility of a takeover that aligns managers' interests to those of shareholders. While these benefits may be substantial,[6] the available empirical evidence shows that hostile takeovers that do occur are not targeted at underperforming companies.[7] Further, this disciplinary device also has a negative side. The threat of hostile takeovers does not allow managers to protect their firm-specific investments, which are potentially valuable also for shareholders (and other stakeholders as well). If managers face the risk of being ousted following a hostile takeover, they will tend to make less human capital investments of this kind.[8]

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[6] See most recently Jonathan R. Macey, *Corporate Governance: Promises Kept, Promises Broken*, 118-122 (2008).

[7] See e.g. G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder?*, 55 J. FIN. 2599 (2000) (evidence for the US); Julian Franks, Colin Mayer, and Luc Renneboog, *Who Disciplines Management in Poorly Performing Companies?*, 10 J. FIN INT. 209 (2001) (evidence for the UK).

[8] For an overview of the literature see Marco Becht, Patrick Bolton, and Ailsa Röell, *Corporate Law and Governance*, in A. Mitchell Polinsky and Steven Shavell (Eds), *Handbook of Law and Economics*, 833, 851-852 (2007).

The second function of takeovers (control reallocation) is equally important, but unfortunately this market is far from perfect. Shareholders' collective action problems on the one hand and the presence of private benefits of control on the other can lead both to the failure of value-increasing ones and to the success of value-decreasing takeovers.

First, shareholders' collective action problems can distort the outcome of takeovers because of the free riding problem. A prospective acquirer will launch a tender offer if the gains exceed the costs. In principle, this is done by identifying undervalued companies, bidding for all of their shares at a price (slightly) above the current one, and, after the purchase, profiting from bringing stock returns to full potential.[9] Unfortunately, due to target shareholders' collective action problems, this strategy is as easy to implement as it looks. Anticipating the higher stock returns, an individually rational shareholder prefers not to tender hoping that the other shareholders will, so as to free ride on the takeover gains.[10] Dispersed shareholders, being unable to coordinate, will all think the same, leading to the takeover failure. That is, unless, of course, the bidder offers them the entire expected post-takeover value increase. But that would deprive the bidder of any profit, which means that she will not launch the bid to begin with.

Free riding is less severe in the real world than theory predicts, but the substantial gains accruing to target shareholders are evidence of its existence.[11] One prominent reason why the free riding problem is not as extreme as theory predicts is that

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[9] See Henry G. Manne, *Mergers and the Market for Corporate Control*, 76 J. POL. ECON. 110 (1965).
[10] This problem was first discussed analytically by Sanford J. Grossman and *Oliver D. Hart*, *Takeover Bids, The Free-Rider Problem and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980).
[11] See Burkart and Panunzi, *Takeovers*, ECGI Finance Working Paper No. 118/2006, 12-17.

target shareholders face a second collective action problem, i.e. pressure to tender[12]. Because they decide whether to tender based on the expected post-takeover share value relative to the bid price, bidders can force shareholders to tender by "fixing" a post-takeover value for holding-out shareholders lower than the bid price. One way to implement this strategy is by declaring in advance that after the takeover the target company will be merged into the parent company on the basis of an exchange ratio that values the target shares less than the bid price (that, of course, in jurisdictions where company and securities laws do not forbid a similar merger). While such a bid structure effectively solves the free riding problem, it prompts dispersed target shareholders to accept even bids in which the expected post-takeover value is lower than the pre-acquisition value. In other words, it makes even value-decreasing bids possible.[13]

All major jurisdictions, including EU ones and the EC itself, provide for rules that aim to solve, or at least alleviate, the pressure to tender problem. In doing so, however, they bring back the free riding problem to the foreground and therefore negatively affect value-increasing bids. They also make all tender offers more costly, and therefore less profitable for bidders. At the margin, thus, they have a negative impact on value-increasing takeover bid activity.

An alternative to laws aimed to protect target shareholders against pressure to tender is to let individual companies themselves devise contractual solutions to it, such as charter provisions granting a majority of the shareholders or the corporate board a veto over the takeover. A private ordering solution to the free riding and pressure to tender problems has the great advantage of allowing for adaption of the response to the

[12] See e.g. Lucian A. Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, in 12 DEL. J. CORP. L. 911 (1987).
[13] See e.g. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986).

specific characters of each individual company. Whether a company's control should be more or less contestable is in fact a function of a number of variables, such as its ownership structure, the levels and kind of private benefits available to those in control and the relative importance of managerial firm-specific human capital investments. A company's shareholders, whether at the IPO stage or mid-stream, are ultimately in the best position to strike the balance between all such variables. A one-size-fits-all solution devised by lawmakers will inevitably make some companies more open to the market for corporate control, and some others more protected from its disciplining and/or re-allocation effects, than it would be optimal.

The framework is different in the presence of a controlling shareholder, but again control transfers can be value-creating as well as value-decreasing and the conclusion to be reached is the same as before, i.e. private ordering is better than one-size-fits-all solutions. Here, changes in control are normally operated by voluntary exchanges of the controlling block.[14] The main problem is that the acquirer's gains can come from the extraction of higher pecuniary private benefits of control and/or from better management, synergies and so on. If the difference between the seller's private benefits of control and the acquirer's is negative and significant enough, the acquirer can profit from the transaction even if the overall value of the company under her control is lower than under the seller's. In other words, the acquirer's gains can be the minority shareholders' losses. A solution to this problem is the mandatory bid, which forces the acquirer to extend to minority shareholders the same terms of purchase offered to the seller, thereby ruling out inefficient takeovers. Unfortunately, the

[14] For a comprehensive analysis of this setting, see Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957 (1994).

mandatory bid also reduces the number of successful value-increasing takeovers, because of the additional costs of paying the control premium to minority shareholders.

The negative impact of mechanisms protecting minority shareholders from expropriation in negotiated control transfer settings generally depends on the relative importance of private benefits of control for the seller and the acquirer,[15] which in turn depends on factors like ownership structure, the company's business, the regulatory environment, and so on. Then, again, the decision on whether to sacrifice efficient allocation of corporate control in the name of investor protection (or vice-versa) should be left to individual companies.

To conclude, takeover regulation should be as neutral as possible, i.e. be designed in such a way as to neither hamper nor promote takeovers via (inevitably) one-size-fits-all solutions. This implies mainly deferring to private parties' choices, but there still is a role for the law to play, and especially for EC (or federal) law, as section 5 shows. Before describing how a takeover-neutral EC law would look like, let us see how distant current EC law is from this approach.

3. The current EC approach: (1) the few rules promoting takeovers

As we have seen in the previous section, the market for corporate control and hostile takeovers more specifically are considered to be highly effective in disciplining managers and are thus a powerful market-based tool to indirectly protect the interests of shareholders. Further, a market in which hostile takeovers can more easily succeed is

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[15] For instance, inefficient control transfers are bound not to happen when the seller's and the acquirer's private benefits are of the same order of magnitude. In this situation, the mandatory bid has only adverse consequences on value-increasing takeovers. See Mike Burkart and Fausto Panunzi, *Mandatory Bids, Squeeze-Out, Sell-Out and the Dynamics of the Tender Offer Process*, in Guido Ferrarini, Klaus J. Hopt, Jaap Winter and Eddy Wymeersch eds., *Reforming Company and Takeover Law in Europe*, 737, 761 (2004).

also one in which cross-border acquisitions will be more frequent, and thus a more integrated one. Rules promoting takeovers are therefore justified both because they indirectly protect the interests of shareholders (Article 44(2)(g), EC Treaty) and because they are instrumental to market integration, one of the foundations of the European Union. It is thus surprising how few the provisions of this kind are in EC Directives generally, and even specifically in the TBD. Here is the list:

a. Articles 9, 11, and 12 of the TBD, requiring Member States to at least allow companies to opt for the board neutrality rule and the break-through rule;[16]
b. At least if broadly construed, the Second Company Law Directive's provisions on pre-emptive rights and equal treatment (Articles 29 and 42) rule out the possibly most effective defensive device, i.e. the US-style poison pill;[17]
c. The Second Company Law Directive itself makes it harder for boards to adopt other defensive strategies, such as leveraged cash-outs (due to limits on distributions and rules requiring a shareholder meeting resolution on buy backs)[18], targeted issues of shares (via rules requiring a shareholder meeting resolution to restrict or withdraw pre-emptive rights provisions)[19], and to execute leveraged management buy-outs[20];

[16] To be sure, Article 3(1)(c) TBD spells out the principle that "the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid." It is doubtful, however, whether this principle has any operational value in the law in action for any company that is not subject to Articles 9 and 11. Similarly, the fact that the board neutrality and break-through rules are the "EC" default means these rules have hardly any operational impact, because member states can opt out.
[17] See e.g. Jeffrey N. Gordon, *An American Perspective on Anti-Takeover Laws in the EU: The German Example*, in Guido Ferrarini, Klaus J. Hopt, Jaap Winter and Eddy Wymeersch eds., *Reforming Company and Takeover Law in Europe*, 541, 551 n23 (2004).
[18] See Articles 15 (limits on distributions) and 19-22 (buy-backs).
[19] Article 29(4), Second Company Law Directive. See also Article 29(5) of the same, which allows member states to delegate the power to restrict or withdraw pre-emption rights to the body that has been delegated to issue new shares.
[20] Article 23a, Second Company Law Directive.

d. Article 46 of Directive 2001/34/EC provides that shares admitted to official listing must be freely negotiable (para. (1)). A derogation to this principle, in the form of an approval of purchases of shares e.g. by the board, is only allowed "if the use of the approval clause does not disturb the market" (para. (3)), a sufficiently vague formulation as to make board approval even of purchases of shares above a given threshold of dubious legality;[21]
e. Article 10 of the TBD, requiring companies to provide detailed information on their ownership structures and any anti-takeover devices, thus lowering (however little) the costs potential bidders have to incur to identify targets;
f. Article 15 of the TBD, requiring member states to grant bidders squeeze-out rights at certain conditions, because squeeze-outs are an effective solution to the free riding problem[22];
g. Article 3 of Regulation (EC) No. 2273/2003, identifying the eligible purposes a company may pursue in order to be exempted from the market abuse prohibitions when buying its shares back (safe harbour).[23] Defending against a hostile bid is not one of them. Although operating outside the safe harbour should not *per se* be regarded as abusive, it entails a higher legal risk, therefore discouraging buy-backs as a defensive measure.

4. The current EC approach: (2) the many rules hindering takeovers

We have seen that takeover bids can also harm shareholders' interests by exploiting the collective action problem of the target shareholders as against the bidder.

[21] Cf. Guido Ferrarini, *Le difese contro le o.p.a. ostili: analisi economica e comparazione*, 2000 RIVISTA DELLE SOCIETÀ 737, 746 (describing national listing requirements requiring free transferability of shares and noting that the original intent of the EC provision was not to promote takeovers).
[22] See Burkart and Panunzi, *supra* note 15, at 747.
[23] Art. 3 of Commission Regulation (EC) No. 2273/2003 of 22 December 2003.

Other stakeholders, like creditors and employees, may also stand to lose if a takeover bid succeeds.[24] Under the implicit assumption that private parties themselves have no more efficient ways to address these problems, the TBD contains a number of provisions that, while providing safeguards for shareholders and other stakeholders, have a negative effect on takeover activity. Some provisions in other directives also have this indirect effect. Starting with the TBD, here is a list of its "takeover-hostile" provisions:

a. By providing for equivalent treatment of securities holders of the same class,[25] the TBD appears to rule out the possibility of price discrimination and selective purchases at a higher price during the bid, which would otherwise help bidders lower the acquisition price and/or raise their chance of success;
b. In the context of hostile bids, the mandatory bid rule[26] prevents the bidder from using coercive bid structures such as partial offers (albeit only above the mandatory bid rule threshold, which is for the member states to define) and two-tier tender offers (whereby the price for the second stage of the offer is lower than for the first stage).[27] The mandatory bid rule also makes friendly acquisitions more costly: at the margin, some value-creating transactions may not go through because of such higher costs;[28]
c. The TBD requires a minimum acceptance period of two weeks.[29] The provision raises the cost of acquisitions for bidders in various ways. First, it rules out coercive bids such as the notorious 1960s "Saturday Night Special,"

[24] See Paul Davies and Klaus Hopt, *Control Transactions*, in Reinier Kraakman et al., *The Anatomy of Corporate Law*, 225, 229-30 (2d ed., 2009).
[25] Article 3(1)(a).
[26] Article 5.
[27] See e.g. Paul Davies and Klaus Hopt, *Control Transactions*, *supra* note 24, at 252-4.
[28] *Id*. at 259.
[29] Article 7(1).

an offer launched on Friday night and closing on Monday morning before stock exchange opening[30]. Second, the provision facilitates incumbent boards' reaction. Specifically, it raises the probability of a competing offer, whether by a White Knight or by another third party. Finally, and less importantly, a longer offer period implies higher financing costs;

d. The Directive also requires bidders to submit a detailed offer document for authorization by the competent supervisory authority and to make it public,[31] which has obvious costs, both direct and indirect (especially as regards the risk of liability suits and administrative or even criminal sanctions for incomplete or false information), and further delays completion of the transaction;

e. By requiring immediate disclosure of the intention to launch the bid,[32] the Directive restricts bidders' discretion in deciding when to start their attack, possibly with negative implications, again, on the cost side and the chance of success. Specifically, it may hamper the bidder's ability to build a sufficiently high toehold before share prices incorporate information about the takeover attempt. Further, it gives the target company more time to prepare defences or to find a White Knight;

f. The effect of curbing coercive practices and therefore of raising acquisition costs stems also from granting a sell-out right to remaining shareholders after highly successful completion of the bid (the threshold being between 90 and 95 percent, depending on States' choice). This is in fact like a second round as

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[30] See e.g. Ronald J. Gilson and Bernard S. Black, *The Law and Finance of Corporate Acquisitions* 734 (1995).
[31] Article 6.
[32] Article 6(1).

envisaged by the takeover regulations of some countries to avoid pressure to tender[33];

g. While requiring member states to include squeeze-out provisions in their takeover laws, the TBD prevents them from granting such right in broader terms than it envisages. For instance, member states may not allow successful bidders to squeeze-out minorities after reaching a threshold lower than 90 per cent, again with a negative impact on takeover activity;

h. Finally, and least importantly, even the rule that requires target companies to "make public a document setting out its opinion of the bid" has an albeit trivial negative impact on takeover activity, because it requires target companies to bear the direct and indirect costs of preparing and publishing the document. Of course, target companies would always try to communicate with shareholders in the event of a hostile takeover. But they might keep silent when the bid is friendly.

At least two other pieces of EC company law are to mention as "takeover-hostile." First and foremost, the Transparency Directive provisions requiring holders of stakes higher than 5 percent to inform the public about their stakes and any subsequent material change[34] have an apparent negative impact on takeover activity, as they directly affect the possibility of building toeholds while the market is still in the dark about a raider's intentions.[35] Second, the Second Company Law Directive provides for

[33] See e.g. Rule 31.4 of the the UK Takeover Code; for Germany, § 21(5) WpÜG.
[34] Articles 9 and 10, Transparency Directive.
[35] See e.g. Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982).

particularly "onerous conditions"[36] for the legality of financial assistance transactions, thus curbing leveraged buy-out activity, however little, at the margin.[37]

While non-binding for Member States, another piece of EC policymaking in the area of corporate law may affect takeover activity: the Commission Recommendation on the regime for the remuneration of directors of listed companies of 30 April 2009. If implemented by the Member States, the limits it sets on termination payments and share payments and options would make it harder for companies to design incentive compensation schemes aligning managers' interests with those of shareholders in the event of a takeover. More precisely, the Recommendation provides that "[t]ermination payments should not exceed a fixed amount or fixed number of years of annual remuneration, which should, in general, not be higher than two years of the non-variable component of remuneration or the equivalent thereof" and that "[s]hares should not vest for at least three years after their award;" further, "[s]hare options or any other right to acquire shares or to be remunerated on the basis of share price movements should not be exercisable for at least three years after their award."[38]

As Professors Kahan and Rock have argued, the US corporate environment adapted to Delaware courts' decisions upholding poison pills by making greater use of stock options with features such as accelerated vesting upon a change of control.[39] If Member States were to implement the Recommendation's provisions on share-based compensation and termination payments, it would become much harder to lure directors' into "accepting" hostile takeovers (i.e. into refraining from adopting available

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[36] Article 23. See critically Eilís Ferran, *Regulation of Private Equity - Backed Leveraged Buyout Activity in Europe* 25-30 (May 2007). ECGI - Law Working Paper No. 84/2007. Available at SSRN: http://ssrn.com/abstract=989748.
[37] See *Ibid*.
[38] See §§ 3.5 and 4, Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (C(2009) 3177).
[39] See Ed B. Rock and Marcel Kahan, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 896 (2002).

defensive tactics, especially in the various countries that have opted out of the board neutrality rule) via such a contract-based device.

This Section and the previous one have briefly outlined the pieces of EC takeover regulation that either promote or hamper takeover activity. There was of course no pretence to cover absolutely all takeover and takeover-relevant regulations. In fact, no mention has been made of the provisions, in the TBD (very few) or elsewhere, pertaining to the protection of employees.[40] While it may be argued that they also have a (very mildly) adverse impact on takeover activity, I have omitted them for the sake of brevity.

To summarise, the EC rules hampering takeovers are more numerous than those promoting them. Because their relative importance varies, it may be subject to debate whether the overall outcome is one rather hindering than promoting takeovers. But intuitively the current regime leans on the side of hampering them.

5. The building blocks of a neutral approach

I have argued that (EC) law should be neutral toward takeovers, i.e. set a framework of rules neither subsidising nor hampering takeover activity, while at the same time leaving individual companies free to choose whether and how easily their control should be reallocated.[41]

That does not imply that there should be no EC law on takeovers, however. In fact, while most of the TBD rules making takeovers riskier and costlier or promoting

[40] For a description and an assessment of such provisions see Sjåfjell, *supra* note 4, at 355-66.

[41] In other words, most (EC) rules in this area should be optional for private parties, whether as default rules (allowing opt-out) or menu provisions (allowing opt-in). See generally Gérard Hertig and Joseph McCahery, *Optional rather than Mandatory EU Company Law: Framework and Specific Proposals*, 2006 ECFR 341 (advocating a wider use of optional law by EC company lawmakers).

them should be scrapped, harmonising measures in this area are still justified on three grounds.

First, the EC's fundamental aim of promoting market integration makes it a good candidate to act as a countervailing force against member states' tendency to devise rules that protect incumbents and therefore hinder takeover activity[42]. In other words, EC law should ideally rule out member states' ability to issue rules of that kind.

Second, there is a clear conflict of interest between managers or block-holders and (other) shareholders in defining a company's policies vis-à-vis takeovers, whether hostile or friendly, and in implementing it. Managers and block-holders will have the upper hand at both stages, if anything due to shareholders' collective action problems, and therefore push for a low degree of contestability or greater freedom to sell or consolidate control. It makes sense thus for a takeover-neutral policymaker to devise default rules that tilt on the side of more contestability (in management-controlled companies) and on the side of more shareholder protection (in companies with a controlling shareholder).

Third, because of the mandatory structure of many European company laws, both in general and with regard to takeovers specifically, a neutral approach to takeovers should aim to remove national company law barriers to contractual freedom in designing corporate policies on control contestability. Menu (opt-in) rules should be used for this purpose.

a. Limiting member states' freedom to enact or retain incumbent-friendly rules. Well before the TBD, many member states had issued rules hampering takeover

[42] On such tendency by lawmakers see e.g. Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987). More recently, see Guido A. Ferrarini and Geoffrey P. Miller, *A Simple Theory of Takeover Regulation in the United States and Europe*, CORNELL INT'L L.J. (forthcoming).

activity. The EC may have a role in shaping EU takeover policy by enacting pre-empting rules, i.e. rules that limit member states' freedom to tamper with takeovers. Because of the political saliency of takeovers and of the varying preferences among national polities with regard to such transactions, it would be politically impracticable to do anything more than setting limits on member states' takeover-hostile intervention. In other words, it is recognized here that an outright ban on takeover-hostile national laws would never possibly pass.

Various EC pre-empting rules can be thought out. Here are some examples.

1. Because disclosure obligations for owners of major shareholdings discourage takeover activity by limiting the freedom of soon-to-be bidders to build toeholds in the target company, the EC should prevent member states from defining too low a threshold. It should also require member states to grant those who launch a takeover bid within, say, one month from the date when the threshold was crossed, an exemption from such obligations. Of course, EC legislation should allow individual companies freely to "opt down" to a lower initial threshold or "opt up" to a higher one. They should also let them opt out of the exemption for prospective bidders. Finally, because this is an area in which other policy considerations may drive national policymakers, EC legislation should *allow* Member States, first, to define minimum and maximum thresholds, below or above which individual companies may not opt down or up, and, second, to define a threshold (not lower than an EC-defined minimum threshold) above which even prospective bidders have to disclose their holdings.

2. EC legislation should not require bidders to publish an offer document. Because it has always been a hallmark of takeover legislation, it is realistic to let member states retain this requirement. In that case, however, EC legislation should

specify that national rules may not make its publication conditional upon prior authorization by the supervisory authority.[43] Further, individual companies should be free to require bidders to issue such a document.

3. Similarly, EC legislation should not fix a minimum offer period. It may, however, provide for a maximum length of the minimum offer period member states might want to impose. In that case, however, EC rules should provide that companies' charters may impose a higher or lower minimum offer period.

4. Again similarly, EC legislation should not require immediate disclosure of a bidder's intentions, while not preventing Member States from imposing it. However, EC rules should require Member States to allow companies to opt out of such a requirement.

5. Finally, it is out of the scope of this paper to assess whether limits on termination payments, stock grants and stock options such as those recommended by the European Commission[44] are justified in general. But we have seen that compensation schemes, like golden parachutes and stock options with accelerated vesting in the event of a takeover, have proved an extremely useful device to align managers' interests to those of shareholders in the event of a takeover in a jurisdiction, like the US, that admits board veto on takeovers.[45] Therefore, if those limits are not to be scrapped entirely, EC legislation should at least provide that they do not apply to compensation devices targeted at takeover situations. By the same token, it should prevent Member States

[43] A rule of this kind would be similar to the provisions in Directives 92/49/EEC and 92/96/EEC that prevent member states from requiring prior approval of "general and special policy conditions … [and] forms and other printed documents which an assurance undertaking intends to use in its dealings with policy holders." See Articles 6, 29 and 39 Council Directive 92/49/EEC of 18 June 1992, and Articles 6(5), 34 and 45 Directive 2002/83/EC of 5 November 2002.
[44] See *supra* note 38 and accompanying text.
[45] See *supra* note 39 and accompanying text.

from imposing themselves limits on compensation devices that are specifically related to takeover events.

b. Default rules protecting (minority) shareholders. The right default rules can help private parties reach better outcomes in their negotiations.[46] I follow here Bebchuk and Hamdani's intuition that "[w]henever public officials face a choice between two default arrangements, one more restrictive and one less restrictive with respect to management, erring on the side of the more restrictive arrangement would carry with it a certain important advantage,"[47] i.e. that "relatively little will be lost because both shareholders and managers will support a charter amendment opting out of this inefficient arrangement."[48] In contrast, as Bebchuk and Hamdani observe, "when opting out requires a charter amendment, if the nonrestrictive arrangement is chosen and then turns out to be inefficient, it might often persist despite its inefficiency,"[49] because managers (and/or controlling shareholders) might gain in private benefits more than they lose *qua* shareholders.

In the presence of a trade-off between minority shareholder protection and promotion of takeovers, a neutral lawmaker should choose the default rules depending on whether investor protection or contestability is more relevant to counter the self-interested behaviour of the controlling agent. When a dominant shareholder is in place, control entrenchment prevails anyway, whereas control transfers can be a form of shareholder expropriation. When managers are in control, that risk is less relevant than the adverse effects of entrenchment. Default rules should err on the side of minority

[46] See generally Ian Ayres, *Optional Law*, 142-65 (2005).
[47] Lucian A. Bebchuk and Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U.L. REV. 489, 492 (2002).
[48] Id. at 492-3.
[49] Id. at 493.

shareholder protection in the former case, and on the side of contestability in the latter. Although admittedly it would be difficult to design rules the application of which depends on the company's control structure, there are five issues in takeover law that the EC would best legislate upon via default rules of this kind.

1. First, because the mandatory bid rule is a safeguard for minority shareholders in the event of opportunistic control transfers, it would make sense for the EC to craft it as a default rule. Individual companies should be free to opt it out. Of course, this may imply that a higher than optimal number of companies would be subject to the mandatory bid rule than if there was no such default. But because the current regime in the EU provides for no opt-out, under the proposed rule European companies would be at least no less open to (friendly and hostile) takeovers than they are now, and some of them may become more so.

2. Action in concert is a necessary anti-evasion component of the mandatory bid rule, but it also has a negative impact on useful forms of coordination among shareholders for monitoring and governance purposes and therefore may harm minority shareholders' overall position in a given company. Because the overall effect on minority shareholders is unclear, EC legislation may define "acting in concert" for the purposes of the mandatory bid rule strictly (i.e., so as not to hamper minority shareholder coordination on governance issues), but grant individual companies the freedom to provide for a different (whether stricter or broader) definition.

3. Tender offers launched by shareholders already controlling the company, normally with a view to delisting it (internal tender offers), are functionally equivalent to self-dealing transactions.[50] Because collective action problems may lead shareholders

[50] See e.g. Ronald J. Gilson and Jeffrey Gordon, *Controlling Controlling Shareholders*, 152 U. PENN. L. REV. 785 (2003).

to accept low-ball bids that allow dominant shareholders to appropriate a disproportionate share of the company's value, EC default rules should provide for mechanisms to protect minority shareholders, such as a separate approval of the bid by a majority of the tendering shareholders. (Member States should, however, be free to treat such transactions as self-dealing ones, and accordingly apply their rules on self-dealing also to companies opting out of the EC default rules on internal tender offers.)

4. Article 9 of the TBD sets the board neutrality rule as an "EU" default, in the sense that member states are free not to implement it even as a default, provided they allow companies to opt into it, which no one does[51]. Given managers' aspiration to be protected from takeovers on the one hand, and shareholders' collective action problems in obtaining a charter amendment, on the other, it will be much easier for a company to opt-out of the default board neutrality rule than to opt into it if "no neutrality" is the default. Therefore, Article 9 should be converted into a real default rule for EU companies: member states would have to implement it as a default rule, and only individual companies would be free to opt out.

5. Finally, the squeeze-out rule is an effective solution to the free riding problem in takeovers. EC legislation should require Member States to grant acquirers of corporate control, whether via a takeover bid or otherwise, the squeeze-out right in broad terms (such as following the acquisition of a simple majority of the shares), but companies should be free to "opt up" to a higher threshold or opt it out completely. Again, managers (and *de facto* controlling shareholders) will have sufficient incentives to opt up or opt out if the default is pro-takeovers. To be sure, the squeeze-out right could also be (ab)used by dominant shareholders outside the takeover context. But

[51] See Klaus J. Hopt, *Obstacles to Corporate Restructuring: Observations from a European and German Perspective*, in Michel Tison et al. eds., *Perspectives in Company Law and Financial Regulation. Essays in Honor of Eddy Wymeersch*, 373, 380 (2009).

given the default on internal tender offers, the possibility of a squeeze-out following an internal tender offer either is taken care of by the different default rule outlined above or is just a by-product of opting out from such a default rule.

c. Menu rules. The mandatory structure of company law in many European countries and at the EC level can hinder individual companies' ability to devise protections against takeovers. Such protections may pursue the legitimate interests of incumbent managers or dominant shareholders, who might want stability of control as a *quid pro quo* for firm-specific human capital investments and/or for management monitoring. They may also aim to solve shareholders' collective action problems vis-à-vis takeover bids. And they may do both.

The EC should enact menu rules that allow individual companies to deviate from the legally defined (and in some countries legally mandated) degree of control contestability. For example, EC legislation should require member states to allow companies to grant the board of directors a veto power on takeover bids or any other equivalent mechanism (like a poison pill).[52] A provision like that would be extremely useful to permit companies that opted out of the board neutrality rule not to enter potentially harmful courses of action (such as leveraged cash-outs) to fend off hostile bids, because a veto power or a poison pill are, as Jeffrey Gordon put it, like a neutron bomb, "destroying" bids while leaving the company operationally untouched.[53] Opening to this kind of defences would allow EC policymakers to leave Second Company Law Directive restrictions on dividends and so forth[54] in place, because the defences they

[52] It should of course be possible to restrict the veto power (or use of the poison pill) to specific kinds of bids (such as coercive ones, or those with a premium lower than *x* percent above market price). A no-poison pill default would be in the same logic as Bebchuk and Hamdani's theory of default rules in corporate law. See Bebchuk and Hamdani, *supra* note 47, especially at 513-5.
[53] See Gordon, *An American Perspective*, *supra* note 8.
[54] See *supra* note 18 and accompanying text.

hamper are simply not needed once a veto power is available.[55] Similarly, EC legislation should require member states to allow companies to adopt mechanisms, other than a board veto, that solve shareholders' collective action problems *vis-à-vis* bidders. For instance, companies should be allowed to require bidders to re-open bids for their shares once the offer has become unconditional.

Further, although the practical impact would be very limited, EC legislation should require Member States to allow companies to opt into the break-through rule (Article 11 TBD)[56], while there would be no reason for changing the current TBD provision allowing Member States to let companies opt into reciprocity[57].

Finally, Articles 23 and 23a of the Second Company Law Directive make leverage buy-outs more costly, while hardly protecting the interests of creditors.[58] An overhaul of EC takeover regulation could amend those provisions so as to make them menu rules: Member States would be required to allow companies to adopt the safeguards they provide for. While in many Member States such a contractual choice might be possible with no need for an EC menu provision, in others it may be necessary to override mandatory rules e.g. in the area of power allocation between the board and the general meeting.

6. Anticipated criticisms

Various criticisms to the proposed approach can be anticipated and briefly commented upon. One could argue, first, that our proposal would lower the safeguards

[55] Of course, the point here is not that it would be wise to leave such rules in place (see Luca Enriques and Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, (2001) 86 CORNELL L. REV. 1165), but rather that we could ignore the negative effect of such rules on takeover activity.
[56] The break-through rule is provided for in Article 11 TBD.
[57] Article 12(3)-(5) TBD. To be sure, the restrictions in paragraph (5) could be relaxed.
[58] See *supra* notes 36-37 and accompanying text.

for shareholders and other stakeholders, running contrary to the very foundation of EC takeover regulation, which is to be found in Article 44(2)(g). However, it is easy to counter that most existing statutory safeguards against takeovers are in fact anti-takeover measures that individual companies could easily replicate in their corporate charters. Those in control within corporations, whether managers or dominant shareholders, have strong incentives to introduce such safeguards or equivalent ones.

Under the policy approach proposed here, there might well be companies that opt for a higher degree of contestability than envisaged by current EC mandatory rules. These companies would be more prone to (hostile) takeovers and, inevitably, bad takeover practices. It is, however, impossible to say whether such companies' shareholders would be worse off: they should be held to have traded protection against bad takeover practices for a higher likelihood of takeovers, with the related gains and the ensuing greater market discipline for managers. As to other constituencies, such as creditors and employees, again in most companies they should gain in protections from controlling agents' tendency to protect against takeovers.

Another criticism might be that, leaving so much scope for contractual freedom, and given controlling agents' incentives to adopt takeover-hostile charter provisions, the final outcome of such a model shift would be an even less takeover-friendly regime than is currently in place. The easy and blunt answer to such criticism, given the theoretical starting point that takeovers are neither good nor bad, so that policymakers should neither promote nor hinder them would be: so what? More politely, this criticism, if relevant (which is hard to assess, because it is impossible to predict the decrease in contestability of control following individual companies' contractual choices in a

setting in which shareholders would have the final word[59]), would only make the neutral approach less politically palatable and therefore less feasible. But it would not invalidate the foundations of a neutral approach.

Similarly, one may object that leaving companies free to decide whether and how minority shareholders should be protected in the event of a control transfer means granting majority shareholders such a freedom. Even conceding that these will fully internalize the costs of such a choice at the IPO stage, leaving those shareholders free to opt out of the mandatory bid rule and other takeover-related protections for minority shareholders midstream not only would redistribute value from minority to majority shareholders but may also be inefficient.[60] To address this criticism, however, one may qualify the proposals on mandatory bids and internal tender offers made above so as to require a qualified majority (or a majority of the minority) as a condition to the opt-out decision by individual companies that are already listed on the stock exchange at the time the proposed regime enters into force. There would be no need to extend this regime to companies going public thereafter, because at the IPO stage markets should be able to discount no-opt-out decisions that are not reinforced by a qualified majority or a majority of the minority clause for future opt-outs.

Further, one may counter that takeover law should not be moulded as an isolated piece of legislation, because it has obvious interactions with other corporate and securities law rules. If such rules are non-neutral themselves, then the overall picture of laws more broadly affecting takeover activity might also be less neutral than envisaged.

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[59] This would be a fundamental difference between the proposed neutral approach and the current US regime, in which, whether by default or as a matter of State law, managers are in control of the decision of how contestable a company is to be. Arguably, nowhere in Europe do the legal rules concerning the process by which corporate charters are amended distort it in favor of management as much as in the US.
[60] See generally Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989).

In the previous sections I have shown that a review of EC takeover law would better also take into account other pieces of legislation that do affect takeover activity. But eventually, we cannot expect the EC to revise all company and securities law rules having an even more indirect effect on takeovers. So, indeed it is possible that the final outcome of a review according the proposed approach will not be complete neutrality. But it would also be the case that, by scrapping most antitakeover laws at the EC level while at the same time introducing pre-emptive rules against protectionist national measures and pro-shareholders and pro-bidders defaults, the outcome will be *more* neutral than is currently the case.

A final criticism could be that giving so much contractual freedom to individual companies would raise uncertainty in the market as to each company's degree of control contestability, thus raising transaction costs for potential bidders. Again, the easy answer from a takeover-neutral perspective, even assuming that so much greater differentiation would ensue than is currently observed, is: so what? However, if this argument is thought to be significant, one could overcome it by retaining Article 10 TBD, which requires disclosure of individual companies' ownership structure and anti-takeover devices.

7. Conclusion

I have argued that policymakers cannot assume that takeovers, whether hostile or friendly, are necessarily good or bad. Nor can they craft takeover rules that hinder all bad takeovers on the one hand, and promote exclusively good ones on the other. As a consequence, the (EC) regulation of takeovers should aspire to be neutral. I have described how such a neutral, mainly optional framework could look like and addressed

likely criticisms to the proposed framework. It is not obvious whether the overall regime resulting from the neutral approach would overall be more or less takeover-hostile than the current EC one, because (national and) contractual choices may tilt towards incumbents protection as opposed to contestability. But given the political hurdles to an enhanced TBD regime, it might be worth considering the neutral approach, or some of the corresponding building blocks, as a possible alternative.

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