

The Non-Frustration Rule after Brexit

Rojina Thapa*

Background

The UK exited the European Union on 31 January 2020. By virtue of this, the EU Takeover Directive ceased to apply in the UK, and thus there was a need to amend the existing regulatory framework on takeovers for it to operate after the UK's exit from the EU.¹ As a result, the Code Committee of the Takeover Panel published a Public Consultation Paper proposing amendments to the Takeover Code.² A Response Statement was also published by the Code Committee with final proposed amendments.³ Final amendments to the Takeover Code were later published in Instrument 2019/3.⁴ Likewise, the Takeovers (Amendment) (EU Exit) Regulations 2019 made the necessary amendment to the Companies Act 2006.⁵

The Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, which entered into force on 31 January 2020, however, states that there shall be 'a transition or implementation period, which shall start on the date of entry into force of this Agreement and end

* Rojina Thapa completed her LLM in International Trade and Commercial Law at Durham University as a Chevening Scholar and practices law in Nepal. Her key areas of practice include commercial law, litigation, arbitration, foreign direct investment, hydropower, banking law and cross-border transactions.

1 Isidora Tachmatzidi, 'Comparative Analysis of Takeover Defenses in Strong and Weak Economies: The Paradigm of the UK and Greece' (2019) 22 *European Research Studies Journal* 254, 258.

2 Public Consultation Paper, 2018/2.

3 Response Statement, 2018/2.

4 The United Kingdom's withdrawal from the European Union, Instrument 2019/3.

5 The Takeovers (Amendment) (EU Exit) Regulations 2019, SI 2019/217.

on 31 December 2020'.⁶ Such transition or implementation period can be extended 'for up to 1 or 2 years', with the decision regarding the extension needing to be taken 'before 1 July 2020'.⁷ The UK decided not to request the extension of the transition or implementation period and thus the period ended on 31 December 2020.⁸

The first part of this article discusses the Takeover Code and the Takeover Panel. This is then followed by an examination of the rules of the Takeover Code relating to the non-frustration rule. The article then delves into the duties of directors under the company law regime and expounds the desirability of the non-frustration rule. The article concludes by stating that the amendment to the regulatory framework on takeovers does not bring about a substantial change to the current regime and calls for the abolition of the non-frustration rule.

Takeover Code and Takeover Panel

The term 'takeover' is commonly used when one company (offeror) acquires a majority or the whole of the shares of another company (offeree) from its shareholders in exchange for cash and/or securities.⁹ 'Takeovers' includes bids for publicly traded companies. A sale of a public company that is not publicly traded or a private company is executed through private negotiation.¹⁰ The purpose of an offer, also known as a takeover bid, is for the bidder (offeror company) to gain control over the offeree company, and not merely for the transfer of shares.¹¹ A takeover becomes hostile when a takeover offer is launched without the consent of or without communicating to the board of directors of the offeree company.¹²

The emergence of hostile takeovers in the early fifties compelled companies in the UK to adopt defensive measures. The 1960s saw extensive litigation contests regarding takeover defence tactics, which demanded the formulation of an instrument regulating takeover in the UK. The demand materialised with the issue of the City Code on Takeovers and Mergers 1968

6 Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, Art 126.

7 *Ibid*, Art 132(1).

8 EU-UK Statement following the High Level Meeting on 15 June, Statement/20/1067.

9 Stephen D Girvin, Sandra Frisby and Alastair Hudson, *Charlesworth's Company Law* (London: Sweet & Maxwell 2010), 782.

10 Brenda Hannigan, *Company Law* (Oxford: Oxford University Press 2009), para 26.1.

11 Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Oxford: Hart Publishing 2015), 677.

12 Alexandros Seretakis, 'Hostile Takeovers and Defensive Mechanisms in the United Kingdom and the United States: A Case Against the United States Regime' (2013) 8 Ohio State Entrepreneurial Business Law Journal 248, 253.

(the ‘Takeover Code’).¹³ Since 1968, takeover bids in public companies have been guided by the Takeover Code and administered by the Panel on Takeovers and Mergers (the ‘Takeover Panel’).¹⁴

Any reference in the Takeover Code ‘to “takeovers”, “takeover bids”, “bids” and “offers” include all transactions subject to the Code’.¹⁵ Apart from regulating takeover bids and merger transactions, the Takeover Code also regulates:

‘other transactions (including offers by a parent company for shares in its subsidiary, dual holding company transactions, new share issues, share capital reorganisations and offers to minority shareholders) which have as their objective or potential effect (directly or indirectly) obtaining or consolidating control of the relevant companies, as well as partial offers (including tender offers...) to shareholders for securities in the relevant companies. The Code also applies to unitisation proposals which are in competition with another transaction to which the Code applies.’¹⁶

In addition to providing ‘orderly framework’ for the takeover, the Takeover Code aims to ‘ensure that shareholders in an offeree company are treated fairly and are not denied an opportunity to decide on the merits of a takeover and that shareholders in the offeree company of the same class are afforded equivalent treatment by an offeror’.¹⁷ It aims to provide the market, including shareholders in an offeree company, with information about the strategy of a bidder.¹⁸ The Takeover Code relies on the informal enforcement mechanism rather than on court enforcement.¹⁹ Several changes have been made in the Takeover Code since its formulation but its main principles, most notably the fair and equal treatment of the shareholder, and rules have remained unchanged.²⁰

The Takeover Panel has been entrusted with the responsibility of regulating takeover activity in the UK.²¹ Panel members are appointed

13 Simen H Stokka, ‘Defence Tactics in Hostile Takeovers: An Analysis of the Rules Imposed on the Pursued Target’ (2013) 3 Southampton Student Law Review 1, 1–2.

14 Jonathan Makwiri, ‘The End of History for the Board Neutrality Rule in the EU’ [2019] European Business Organization Law Review, see <https://doi.org/10.1007/s40804-019-00164-w> accessed 14 April 2020.

15 See n 4 above.

16 City Code on Takeovers and Mergers (12th edn 2016), s 3(b).

17 *Ibid.*, s 2(a).

18 See n 12 above, 791.

19 John Armour, Jack B Jacobs and Curtis J Milhaupt, ‘The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework’ (2011) 52 Harvard International Law Journal 219, 258.

20 See n 15 above, 253.

21 See n 12 above, 783.

by several entities such as ‘insurers, investment companies, private and institutional investment management firms, banks, industry, accounting firms, investment banking houses and pension funds’.²² Section 943(1) of the Takeovers (Amendment) (EU Exit) Regulations 2019 requires the Takeover Panel to make rules ‘giving effect to the general principles in Part 1 of Schedule 1C’ and ‘in accordance with Part 2 of that Schedule’.²³ Part 1 of Schedule 1C has stated verbatim general principles as enshrined in the Takeover Code, whereas Part 2 deals with the provisions related to the protection of minority shareholders, the mandatory takeover bid and the equitable price.²⁴ Likewise, section 943(2) authorises the Takeover Panel to make provisions for regulating ‘takeover bids’.²⁵ The Takeover Panel has the power to make rules, to require the disclosure of information and documents, to apply to a court for enforcement orders and to impose sanctions on a person violating the Takeover Code.²⁶

The Takeover Panel did not have statutory power and was self-regulated prior to the implementation of the EC Takeover Directive in the UK.²⁷ Article 4(1) of the EC Takeover Directive required Member States to ‘designate the authority or authorities competent to supervise bids’ and such authority could be ‘either public authorities, associations or private bodies recognised by national law or by public authorities expressly empowered for that purpose by national law’.²⁸ To this end, the Companies Act 2006 provides statutory power to the Takeover Panel, stating that the Panel ‘may do anything that it considers necessary or expedient for the purposes of, or in connection with, its functions’.²⁹ Earlier, when the Takeover Panel did not have statutory power, compliance with the Takeover Code was secured through a process known as ‘cold shouldering’, where the violator was excluded from investment transactions.³⁰

22 Brian E Rosenzweig, ‘Private Versus Public Regulation: A Comparative Analysis of British and American Takeover Controls’ (2007) 18 *Duke Journal of Comparative & International Law* 213, 216.

23 See n 5 above.

24 *Ibid.*

25 Companies Act 2006.

26 See n 13 above, para 26.14.

27 Wan Wai Yee, ‘Enforcing Public Takeover Regulation: Reconciling Public and Private Interests’ (2019) 31 *Singapore Academy of Law Journal* 285, 288.

28 Council Directive 2004/25/EC of 21 April 2004 on Takeover Bids [2004] OJ L142/12 (EC Takeover Directive).

29 See n 28 above, s 942(2).

30 See n 16 above, 2–3.

Non-frustration principle

The regulatory regime of the UK in relation to takeovers has embraced a shareholder-centred approach.³¹ The consent of shareholders is required before taking any defensive measure in the UK.³² As a result, the board neutrality rule or the non-frustration principle, as referred to in the UK, is treated as a central element of the Takeover Code.³³ The non-frustration principle has been enshrined in General Principle 3 and Rule 21 of the Takeover Code. It connotes that directors of the offeree company are prohibited from taking any defensive measures that encroach upon the freedom of the shareholders to decide whether to accept the offer. The non-frustration principle applies when a bona fide offer is imminent.³⁴ Since the 1960s, the boards of publicly traded companies in the UK have been prohibited from deploying defensive measures in relation to takeovers. The reason behind the prohibition was to restrict the board from misusing corporate power, thereby frustrating an imminent or ongoing takeover bid without the approval of the shareholders.³⁵

Buying a large stake in a company at a substantial premium, known as a 'Greenmail' defence measure, and the commonly used defence in Delaware jurisprudence known as a 'poison pill' amount to a frustrating action under Rule 21.³⁶ It also prohibits a restructuring defence, which encompasses the declaration of dividends distribution, an increase in company debt levels, buyback of shares or issuing of a substantial block of shares to a friendly third party.³⁷ Since the Takeover Panel must be consulted to make sure that any action taken by the board of the offeree company does not contradict the Takeover Code, defensive measures are restricted in all circumstances in the UK.³⁸

31 Jennifer Payne, 'Schemes of Arrangement, Takeovers and Minority Shareholder Protection' (2010) Oxford Legal Research Paper Series Paper No 42/2010, 6, see <http://ssrn.com/abstract=1600592> accessed 26 April 2020.

32 John Armour and David A Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why?: The Peculiar Divergence of U.S. and U.K. Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727, 1736–1737.

33 Matthew Peetz, 'Protecting Shareholders from Themselves: How the United Kingdom's 2011 Takeover Code Amendments Hit Their Mark' (2013) 2 *Penn State Journal of Law & International Affairs* 409, 416.

34 See n 14 above, 696.

35 Chrispas Nyombi, 'A Critique of Shareholder Primacy under UK Takeover Law and the Continued Imposition of the Board Neutrality Rule' (2015) 57 *International Journal of Law and Management* 235, 241.

36 See n 16 above, 7.

37 See n 38 above, 243.

38 See n 16 above, 7.

General Principle 3 of the Takeover Code

The General Principles enshrined in the Takeover Code are the statements of standards of commercial behaviour aimed at achieving their underlying purpose.³⁹ General Principle 3 of the Takeover Code states that ‘[t]he board of directors 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’.⁴⁰ This principle ensures that it is the holders of the securities who decide for themselves on the desirability or otherwise of the takeover bid.⁴¹

Rule 21 of the Takeover Code

Article 9(2) of the EC Takeover Directive requires the board of the offeree company to obtain the prior approval of the shareholders ‘before taking any action, other than seeking alternative bids, which may result in the frustration of the bid and in particular before issuing any shares which may result in a lasting impediment to the offeror’s acquiring control of the offeree company’, from the time when it receives information that a bid is to be made until the result of the bid is made public or the bid lapses.⁴² Article 12 has made the said Article optional and Member States can opt out of this provision but the UK has opted in since it is consistent with Rule 21 of the Takeover Code.⁴³

Since its origin, the Takeover Code has imposed substantial restriction on the board of the offeree company from applying defensive measures. The most prominent provision in this regard is Rule 21.⁴⁴ It prohibits the board of the offeree company, ‘[d]uring the course of an offer, or even before the date of the offer’, from taking any action, without the approval of the shareholders, which ‘may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits’ if in case it has ‘reason to believe that a bona fide offer might be imminent’. In particular, the board of the offeree company cannot:

‘issue any shares or transfer or sell, or agree to transfer or sell, any shares out of treasury or effect any redemption or purchase by the company of its own shares; issue or grant options in respect of any unissued shares; create or issue, or permit the creation or issue of, any securities carrying rights

39 See n 13 above, para 26.41.

40 See n 4 above.

41 See n 12 above, 788; also n 13, para 26.42.

42 See n 31 above.

43 See n 13 above, para 26.63.

44 See n 16 above, 2.

of conversion into or subscription for shares; sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount; or enter into contracts otherwise than in the ordinary course of business.⁴⁵

The prohibition is non-exhaustive and it covers other possible ways of deploying takeover defences.⁴⁶ Rule 21, however, only restricts post-bid defences and defences deployed during the takeover offer.⁴⁷

General Principle 3, in this regard, reinforces Rule 21.⁴⁸ The Rule looks to consequences, not to purposes, and thus shareholder approval cannot be given in general and in advance of the bid.⁴⁹ Rule 21, employing a negative obligation, states what the board must *not* do. It does not prescribe an obligation to act positively.⁵⁰

Allowed defensive measure

Rule 21 of the Takeover Code essentially limits pre-bid defensive measures to three options, namely:

1. persuading shareholders to reject the offer and continue their trust with the current management;
2. drawing the attention of the concerned competition authorities towards the public interest grounds of the bid; and
3. encouraging another bidder to make an alternative offer to the shareholders.⁵¹

The prior approval, granted before the board becomes aware of any bid, of the shareholder is nevertheless required for the use of such defences.⁵²

Implementation of the aforementioned pre-bid defensive measures depends on the persuasive power of the board of the offeree company⁵³ and their compliance with the fiduciary duties of the board owed to the offeree company.⁵⁴

45 See n 19 above, rule 21.1(a).

46 David Kershaw, 'Hostile Takeovers and the Non-Frustration Rule: Time for a Re-Evaluation' (2016) LSE Law, Society and Economy Working Papers 19/2016, 5, see <https://ssrn.com/abstract=2875772> accessed 14 April 2020.

47 See n 15 above, 260.

48 See n 16 above, 2.

49 Paul L Davies, *Principles of Modern Company Law* (London: Sweet & Maxwell 2008), 986.

50 *Ibid*, 987.

51 See n 52 above, 987.

52 Carsten Gerner-Beuerle, David Kershaw and Matteo Solinas, 'Is the Board Neutrality Rule Trivial? Amnesia about Corporate Law in European Takeover Regulation' [2015] LSE Research Online, 20, see <http://eprints.lse.ac.uk/39417> accessed 18 April 2020.

53 W Stewart Robinson, 'A Change in the Legal Wind – How a New Direction for Corporate Governance Could Affect Takeover Regulation' (2012) *International Company and Commercial Law Review* 292, 306.

54 David Kershaw, 'The Illusion of Importance: Reconsidering the UK's Takeover Defence Prohibition' (2007) 56 *International and Comparative Law Quarterly* 267, 282.

As per the Enterprise Act 2002, the Secretary of State can intervene in a takeover in certain public interest cases relating to national security, media plurality and financial stability.⁵⁵ Section 42 states that the Secretary of State can present an intervention notice to the Office of Fair Trading if he/she 'believes that it is or may be the case that one or more than one public interest consideration is relevant to a consideration of the relevant merger situation concerned' and the 'public interest consideration is a consideration which, at the time of the giving of the intervention notice concerned, is specified in section 58 or is not so specified but, in the opinion of the Secretary of State, ought to be so specified'.⁵⁶ Section 58 specifies 'national security', 'need for, to the extent that it is reasonable and practicable, a sufficient plurality of views in newspapers in each market for newspapers in the United Kingdom or a part of the United Kingdom' and 'interest of maintaining the stability of the UK financial system' as public interest grounds for intervening in a takeover.⁵⁷ Section 58 also allows the Secretary of State to identify other new considerations that satisfy as public interest considerations.⁵⁸ To this end, section 52 states that the Secretary of State 'may by order modify this section for the purpose of specifying in this section a new consideration or removing or amending any consideration which is for the time being specified in this section'.⁵⁹ Further, section 59, which allows intervention in special public interest cases, states that the Secretary of State can give a special intervention notice to the Office of Fair Trading if he/she 'believes that it is or may be the case that one or more than one consideration specified in section 58 is relevant to a consideration of the special merger situation concerned'.⁶⁰ It is up to the Secretary of State to 'decide whether to make an adverse public interest finding in relation to the relevant merger situation and whether to make no finding at all in the matter'.⁶¹

Directors' duty under company law

The Takeover Code does not cover pre-bid defensive measures and thus the fiduciary duties of directors under the Companies Act 2006 must be looked into.⁶²

55 See n 49 above, 43.

56 Enterprise Act 2002, s 42(2)(3).

57 *Ibid*, s 58(1), (2B), (2D); the Competition (Amendment etc) (EU Exit) Regulations 2019.

58 See n 49 above, 45.

59 See n 59 above, s 58(3).

60 *Ibid*, s 59(2).

61 *Ibid*, s 54(2).

62 Han-Wei Liu, 'The Non-Frustration Rule of the UK City Code on Takeover and Mergers and Related Agency Problems: What are the Implications for the EC Takeover Directive?' (2010) 17 Columbia Journal of European Law 5, 9.

Proper purpose doctrine

Section 171(b) of the Companies Act 2006 incorporates one of the major fiduciary duties of the directors,⁶³ which states that a director must ‘only exercise powers for the purposes for which they are conferred’.⁶⁴ Therefore, directors are required to use their powers only for a proper purpose as per section 171(b) of the Companies Act 2006. The proper purpose doctrine restricts directors from exercising their powers for any collateral purpose.⁶⁵ The doctrine provides that directors can use corporate power to interfere with the takeover offer only in the event that the shareholders have authorised them to do so.⁶⁶ If any action is authorised, other than to interfere in the bid, before the bid then such action can be regarded as lawful.⁶⁷ Several case laws have confirmed that allotting new shares to repel potential takeover does not respect the obligation to use the powers for the intended purposes and to act in the best interest of the company. Byrne J in the case of *Punt v Symons* held that the issue of shares to ward off a takeover was not ‘bona fide for the general advantage of the company’.⁶⁸

Duty of loyalty

The common law duty of loyalty is enshrined in section 172 of the Companies Act 2006.⁶⁹ The section requires a director of a company to act ‘in good faith’ for the promotion of ‘the success of the company for the benefit of its members as a whole’. At the same time, a director should take into consideration ‘the likely consequences of any decision in the long term’, ‘the interest of the company’s employees’, ‘the desirability of the company maintaining a reputation for high standards of business conduct’ and ‘the need to act fairly as between members of the company’ among other matters.⁷⁰ As per this fiduciary duty, directors should exercise the power delegated through the charter document in a loyal manner.⁷¹ If defensive measures are used by directors for their personal benefit then this fiduciary duty is deemed breached.⁷²

63 Chuanman You, ‘The Proper Purpose Rule and the Exercise of Directors’ Power in the Context of a Takeover Battle’ (2017) 38 Business Law Review 2, 3.

64 See n 28 above.

65 See n 38 above, 245.

66 See n 49 above, 8.

67 *Ibid.*

68 See n 12 above, 333.

69 See n 38 above, 245.

70 See n 28 above, s 172(1).

71 See n 55 above, 14.

72 See n 57 above, 282.

Examination of the compliance of a director with section 172 incorporates both the subjective and objective test. The subjective test requires the director to ‘exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company’. Similarly, the objective test involves an examination of ‘whether an intelligent and honest man in the position of a director to the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the interest of the company’.⁷³

Reference to ‘members’ in section 172(1) encapsulates what is traditionally known as shareholders’ primacy to the more recent concept of enlightened shareholder value, which requires the directors to take into consideration the interest of different stakeholders.⁷⁴ The success of the company should be viewed not in the ‘individual interests of members, but their interests as members of an association with the purposes and the mutual arrangements embodied in the constitution’.⁷⁵ Lord Goldsmith in the Grand Committee of the House of Lords stated that ‘for a commercial company, success will normally mean a long-term increase in value, but the company’s constitution and decisions made under it may also lay down the appropriate success model for the company’. Also, investors in companies ‘want a long-term increase in the company’.⁷⁶ Directors of a company ‘should take into account the long term’ and a successful company cannot be planned by ‘looking at short-term gain and short-term popularity, be it on the stock market or in the eyes of members of the company’.⁷⁷ The statutory requirement under the said section is the needs of members as opposed to success in a more general sense.⁷⁸

73 Alan Dignam and John Lowry, *Company Law* (Oxford: Oxford University Press 2012), paras 14.27–14.28; see n 13 above, para 9.3.

74 Collins CAjibo, ‘A Critique of Enlightened Shareholder Value: Revisiting the Shareholder Primacy Theory’ (2014) 2 *Birkbeck Law Review* Volume 37, 46; Blanaid Clarke, ‘Directors’ Duties during an Offer Period – Lessons from the Cadbury Plc Takeover’ (2011) UCD Working Papers in Law, Criminology & Socio-Legal Studies Research Paper No 44/2011, 3, see <http://ssrn.com/abstract=1759953> accessed 24 April 2020; Chrispas Nyombi, Tom Mortimer, Rhidian Lewis and Georgios Zouridakis, ‘Shareholder Primacy and Stakeholders’ Interests in the Aftermath of a Takeover: A Review of Empirical Evidence’ (2015) *International Business Law Journal* 161, 168.

75 *Company Law Review*, ‘Modern Company Law for a Competitive Economy: Developing the Framework’ (URN 00/656, 2000), para 3.51.

76 HL Deb 6 February 2006, vol 678, col 258.

77 *Ibid*, col 237.

78 See n 12 above, 328.

Long-term shareholder value or short-termism

There are divided opinions as to whether takeover or the threat of takeover is boon or bane. Some argue that it disciplines the management of the company and encourages efficiency, whereas others argue, rather, that it forces management of the company to focus primarily in boosting the share price for short-term benefit and to make the takeover futile than to pursue long-term growth through the productive use of assets.⁷⁹

The Companies Act 2006 has not vested much decision-making authority to the board of directors. In UK company law, empowerment of the board of directors is done through the shareholders.⁸⁰ At common law, directors have the fiduciary duty to act bona fide for the interests of the shareholders as a general body. They should balance short-term interests against the long-term interests of shareholders, which is defined primarily in terms of enhancing shareholder value.⁸¹

Section 172 of the Companies Act is also viewed as adopting an enlightened shareholder value approach. The duty clearly establishes the priority of members' interests.⁸² This approach resonates with the approach taken by the Supreme Court of Canada in *People's Department Stores v Wise*, in which the Court stated that acting in the 'best interests of the company required directors to maximise the value of the corporation. This did not mean acting solely in the interests of the shareholders or any stakeholder's interest'.⁸³ However, the Enhanced Shareholder Value principle in section 172 is stated with a high degree of generality, reading very much like a list of good conduct by directors. It is not likely that the principle will act as an agent for change and bring about substantive change in the management of companies in the UK.⁸⁴

Rule 21 prohibits directors from deploying defensive measures that would result in frustration of a takeover bid, unless authorised by the shareholders, even in the case where there is a reason for the board to believe that such a takeover bid is not beneficial for the long-term success of the company.⁸⁵ The board of the offeree company may have an opinion of its own regarding the takeover bid. The takeover may be desired because the board considers it to be in the best interest of the company or undesired because it could

79 See n 13 above, paras 26.6–26.7.

80 David Kershaw, *Company Law in Context: Text and Materials* (Oxford: Oxford University Press 2012), 191–192.

81 See n 13 above, para 9.1.

82 See n 83 above, 382.

83 See n 76 above, para 14.32.

84 Richard Williams, 'Enlightened Shareholder Value in UK Company Law' (2012) 35 UNSW Law Journal 360, 360.

85 See n 77 above, 162.

hamper the business prospects of the company. Directors may as well have a personal vested interest in resisting the takeover.⁸⁶ In case of the latter situation, the threat of a takeover encourages management to concentrate more on shareholder needs, prompting it to promote the short-term interest of the shareholders, which may be detrimental to the long-term development of a company's business.⁸⁷ In such a scenario, the board may assure a return of cash to existing shareholders by way of a special dividend or repurchase of shares, which will have a negative impact on the growth of the company.⁸⁸

Issues related to non-frustration rule

Review of the Takeover Code

Following the much-criticised takeover of Cadbury PLC by Kraft Inc and mounting public pressure, the Code Committee initiated a review of the Takeover Code.⁸⁹ The Code Committee concluded that 'it has become too easy for "hostile" offerors (ie, offerors whose offers are not from the outset recommended by the board of the offeree company) to succeed' and 'hostile offerors have, in recent times, been able to obtain a tactical advantage over the offeree company to the detriment of the offeree company and its shareholders'.⁹⁰ However, it neither questioned nor made any changes in the non-frustration rule.⁹¹

Argument for and against the non-frustration rule

Supporters of the non-frustration rule can argue that:

1. it is the shareholders themselves who should decide on whether to sell their shares or not;
2. in order to avoid the risk of losing a job as a result of the hostile takeover bid, directors can use defensive measures for their own benefit rather than for value-enhancing purpose, thereby creating agency cost problems;
3. the board can potentially exploit collective action problems;

86 See n 12 above, 788.

87 See n 52 above, 985.

88 See n 14 above, 697.

89 Michael R Patrone, 'Sour Chocolate: The U.K. Takeover Panel's Improper Reaction to Kraft's Acquisition of Cadbury' (2011) 8 International Law & Management Review 63, 65; see n 2 above, s 1(a) 1.1.

90 Review of Certain Aspects of the Regulation of Takeover Bids 2010/22, ss 2.5, 2.6.

91 See n 36 above, 429; see n 22 above, 239.

4. any available defensive measure can be implemented with ex post-shareholder approval;⁹²
5. shareholders are at greater risk by investing in companies.⁹³

One argument against the non-frustration rule is that, first, the rule does not serve the interests of rational shareholders having a substantial shareholding in the company. Rational shareholders may want the board to use a defensive measure to ward off the hostile bidder offering a premium for the share of short-term shareholders who will choose a quick gain over the long-term value of the company. Shareholder sovereignty is hence eroded by the prohibition on the use of a defensive measure.⁹⁴ Secondly, as far as agency costs are concerned, the market for corporate control can thwart them. When managers misuse corporate power for personal benefit, it results in a decrease in the company value, which in turn will create an opportunity for the potential bidder, and directors face the risk of losing their job. The scope of agency costs lessens with the more active market for corporate control.⁹⁵ Thirdly, shareholders who do not participate in the corporate affairs of the company pose the threat of approving defensive measures without careful consideration. Even though shareholders have a right to be involved in corporate affairs, they generally do not utilise this right. Not only this, shareholders create free-rider problems, that is, they benefit from the work of active shareholders without contributing anything to corporate affairs.⁹⁶ Fourthly, the non-frustration rule becomes ineffective if ex ante shareholder approval can be invalidated by ex post shareholder approval.⁹⁷ Fifthly, other non-shareholding stakeholders such as employees and creditors also contribute to the company, not just the shareholder. Hence, an act of prioritising shareholders over other stakeholders cannot be justified. In fact, these stakeholders do not have access to the financial condition of the company unlike shareholders and thus are equally at risk on a par with shareholders.⁹⁸

Abolition of non-frustration rule

Evaluating the pros and cons of takeover defences indicates that boards are powerless in the face of a hostile takeover offer and, hence, calls for

92 See n 57 above, 298–306.

93 See n 77 above, 170.

94 See n 38 above, 248–249.

95 See n 57 above, 301.

96 See n 38 above, 250.

97 *Ibid.*, 250.

98 See n 77 above, 171.

changing the balance of power between the offeror and the offeree.⁹⁹ Abolition of the non-frustration rule is appealing for the companies as it provides shareholders with ex ante choice that they do not currently have and it also addresses concerns relating to short-termism and stakeholder investment.¹⁰⁰ Even though the non-frustration rule is abolished, it will not provide the board with the freedom to deploy defensive measures, as in all cases the approval of shareholders is still needed for deployment.¹⁰¹

Abolition of the non-frustration rule will not bring radical change in the power of shareholders as the Companies Act 2006 will continue to keep boards under the command of shareholders.¹⁰² According to section 168 of the Companies Act 2006, a company 'may by ordinary resolution at a meeting remove a director before the expiration of his period of office, notwithstanding anything in any agreement between it and him'.¹⁰³ If shareholders 'representing at least 5% of such of the paid-up capital of the company as carries the right of voting at general meetings of the company' or if the company does not have share capital then shareholders 'who represent at least 5% of the total voting rights of all the members having a right to vote at general meetings' can 'require the directors to call a general meeting of the company' and 'directors are required to call a general meeting once the company has received requests to do so'.¹⁰⁴ Given the multiple stakeholder control in companies, abuse of the power by the boards is unlikely.¹⁰⁵

Conclusion

The amendments made in the regulatory regime relating to takeovers as necessitated by the UK's exit from the EU are technical in nature and do not significantly change the existing regulatory framework. The Takeover Code by virtue of General Principle 3 and Rule 21 continues to prohibit the board of the offeree company from resorting to a takeover defence mechanism once the takeover becomes imminent. These provisions allow the shareholders of a company to decide on the merits of a takeover bid but directors do not enjoy much discretion in influencing the decision of the shareholders, as they need authorisation from the shareholders before taking any action that may frustrate the bid offer. Likewise, company law has entrusted directors to act for the promotion of the success of the company for the benefit of its

99 See n 49 above, 32.

100 *Ibid*, 35.

101 *Ibid*, 33.

102 See n 77 above, 178.

103 See n 28 above, s 168(1).

104 *Ibid*, s 303(1), (2).

105 See n 49 above, 35.

members as a whole. The success of the company is usually defined in terms of a long-term increase in shareholder value. In this situation, directors can be compelled to focus on the short-term profitability of the shareholder to gain their confidence. This phenomenon, in turn, will be detrimental for the long-term success of the company.

Even though the non-frustration rule has been questioned time and again, it has never been reviewed by the Code Committee, and still remains as a central pillar of the Takeover Code. There are arguments both for and against the need for a non-frustration rule but it is recommended that this rule be abolished, as its abolition will not bring radical change in the notion of shareholder primacy in the UK and it is vital in order to change the current balance of power between the hostile bidder and the target company.

