

Regulating the Market for Corporate Control: Lessons from Germany

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Contrary to common belief, takeovers represent an important and frequently employed mechanism for correcting control deficits in German corporations. This article explains the unique character of Germany's market for corporate control on the basis of the wide-spread presence of block ownership. It further discusses the objectives underlying the regulatory structure currently put in place, i.e., the proposed EU Takeover Directive (13th Directive) and the recently introduced German Takeover Code. These provisions include one particularly controversial feature, the requirement to submit a mandatory tender offer on all outstanding securities after a shift in majority control. The paper argues that mandatory tender offers effectively raise economic barriers against takeovers, thereby lower the benefits from block ownership and implicit contracting and are therefore incompatible with Germany's relation-based system of corporate governance.

I. Introduction

The recent past has generated unambiguous signs that Continental Europe is in the process of slowly accepting takeovers, friendly as well as hostile ones, as an essential feature of a well-functioning system of corporate governance. Most notably, the EU Commission's Proposal for a *Takeover Directive*¹ (1996) is providing an effective stimulus for national reform efforts with the intention to export the British model to the rest of the Community. The proposed legislation is based on the rationale that the market for corporate control plays the role of a catalyst for the completion of the Single European Market. Germany had anteceded these developments in 1995 with the introduction of a *Takeover Code*² founded on the principle of self-regulation, i.e., companies may voluntarily accede to the code and thereby accept a private contractual obligation to uphold the principles specified therein.

Germany's Takeover Code is founded on four core principles: (1) the equal treatment of all shareholders, (2) the provision of complete and concise information to shareholders, (3) the prohibition of manipulative actions by the bidder or the target firm's management and (4) the protection of minority shareholder rights. The aim of (1) through (3) is to ensure the fairness of the takeover process from the perspective of the existing shareholders. (4) adds the requirement that the acquirer of a majority stake must give the remaining shareholders the opportunity to „bail out“ and sell their stock at an adequate price. Thus, the *voluntary* offer to acquire more than 50% of the voting stock must be followed, if successful, by a *mandatory tender offer* for the remaining stock outstanding. This provision accounts for the

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possibility that the dominant shareholder abuses his control rights in order to extract private rents from the company and appropriate rightful gains of minority shareholders.³ “Mandatory offer” requirements are not an uniquely German phenomenon. The EU Commission for instance favors a trigger level of 33%; its proposed EU Takeover Directive however grants every Member State the right to set its own threshold. In the UK, a bidder is mandated to make a full offer once his equity stake reaches 30% (Glass [29], 12).

This article has been written with three objectives in mind: first, to analyze the role of takeovers in the German system of corporate governance (section II), second, to present a detailed overview of the takeover legislation currently put in place in the EU and Germany (section III) and, finally, to provide a critical evaluation of the “mandatory offer” requirement in the German context (section IV). One key insight of the paper is that takeovers represent a widely used corrective mechanism to deal with control deficits. We further conclude that the regulation of takeover bids in the EU will be governed by a legislative hierarchy where national and supranational statutes peacefully coexist. EU directives aim at achieving a minimum level of harmonization without forcing Member States into a process of outright convergence. This stands in contrast to the United States where federal and state legislatures are involved in a long-standing struggle over the prerogative to regulate the market for corporate control (see also Hommel/Riemer-Hommel [35]).

The final conclusion of the paper is that “mandatory offer” requirements are an inefficient regulatory mechanism for Germany’s emerging takeover market. The dubious benefit of removing the agency conflict between majority and minority shareholders is coupled with foregone opportunities for implicit contracting⁴ between majority owners and management. As the costs associated with a takeover rise, it becomes less likely that corporate underperformance due to internal monitoring deficiencies will trigger corrective changes in the ownership structure. Germany’s relation-based governance system has for instance hindered the development of domestic financial markets (Dufey/Hommel [16], 198-201) to the degree that strategic corporate investments (e.g. creation of (real) growth options⁵) are only recognized imperfectly by the investment community at large.⁶ In such an environment, block ownership and direct monitoring by shareholders attain vital importance for maintaining a company’s long-term competitiveness. In other words, what may be a fitting regulatory device in the Anglo-Saxon world of explicit contracting and market-based governance can not be employed with similar effectiveness in other parts of the EU.

II. The Role of Block Ownership and Takeovers in Germany’s System of Corporate Governance

Corporate governance regulates the contractual relations between stakeholder groups, in particular the principal-agent relationship between shareholders and management. Ideally, the separation of ownership and control allows shareholders and managers to focus on their respective competitive advantage: the provision of risk capital on the one hand and the management of real investment portfolios on the other hand. In reality, the contractual governance of management behavior is necessarily incomplete and direct monitoring will be underprovided due to its public-good character. Hence, management is in the position to

seize residual control rights in “unanticipated” states of nature and appropriate the shareholders’ investment return (see also Shleifer/Vishny [51], 140-4). If left unregulated, shareholders will underprovide equity finance and companies will not be able to take advantage of all value-enhancing investment opportunities. The codification of corporate governance into national law thus represents a necessary and effective means of alleviating the underinvestment problem and limiting the implied agency costs.

Corporate governance follows a “carrot and stick” approach. Relation-based (or internal) control serves as the “carrot” and allows shareholders to closely interact with management and to create a tight relationship between their own expectations and the management’s incentive structure. In contrast, market-based (or external) control represents the “stick” which regulates management behavior with penalties provided by the markets for corporate control and management labor. The key difference between the U.S. and the German system of corporate governance lies in the relative importance of the aforementioned control mechanisms. While the former relies heavily on self-regulation and market sanctions to eliminate agency problems between owners and management, the latter emphasizes direct monitoring by strategic investors via the supervisory board and, in addition, assigns to management the role of arbitrator between conflicting stakeholder interests. The difference in relative weights of internal vs. external control has implications for virtually every aspect of corporate governance. Table 1 highlights the most important structural and legal differences.

Contrary to common belief, Germany nowadays has not only a well established but also a very unique takeover culture. The frequency of M&A transactions involving large equity blocks had increased significantly between 1985 and 1992, partially triggered by the adoption of the Single European Act (1986) and German reunification (1989), and has remained fairly stable after 1993 (see Figure 1). The increase in M&A activity has however not been followed by a similar increase in the involvement of German investors in takeover transactions - net of Treuhand sell-offs (see Figure 2). Prior to reunification, the acquisition of majority control had been recorded with similar frequency in Germany⁷ and France but still far below the one in the United Kingdom.⁸

These developments have been accompanied by the aggressive market entry of U.S. and British investment banks, German universal banks shifting their M&A activities to newly acquired British subsidiaries⁹ and the concentration of M&A advisory capacity in the City of London. In addition, international financing needs have begun to force German corporations into accepting shareholder value as the primary corporate performance measure. Overall, it appears that - from a U.S. perspective - the distinctive features of the German market for corporate control are gradually vanishing.

Nevertheless, the process of correcting control deficits with a change in ownership structure displays features very different from the British or U.S. takeover market. One important explanatory factor is the high concentration of share ownership typically found in Germany’s listed companies (see Table 2). Jenkinson/Ljungqvist [37] show for a 1991 sample of 558 listed firms that 90.2% (72%) had a block owner holding more than 25% (50%) of the company’s equity.¹⁰ Another study by Prowse [43] reports a 5-shareholder concentration ratio of 41.5% for a 1990 sample of 310 listed non-financial firms. Equity stakes in excess of 25% (commonly referred to as *blocking minorities*) will in many cases be

already an effective deterrent against Anglo-Saxon-type tender offers since they grant veto-powers over corporate charter amendments, changes of the supervisory board and, last but not least, profit-transfer and control agreements. Blocking minorities may actually translate into majorities at the general shareholder meetings of widely held firms considering the fact that the average attendance for a sample of 24 firms has just been 58.04% in 1992 (Baums/Fraune [2], 102).

Table 1
U.S. and German governance structures in comparison

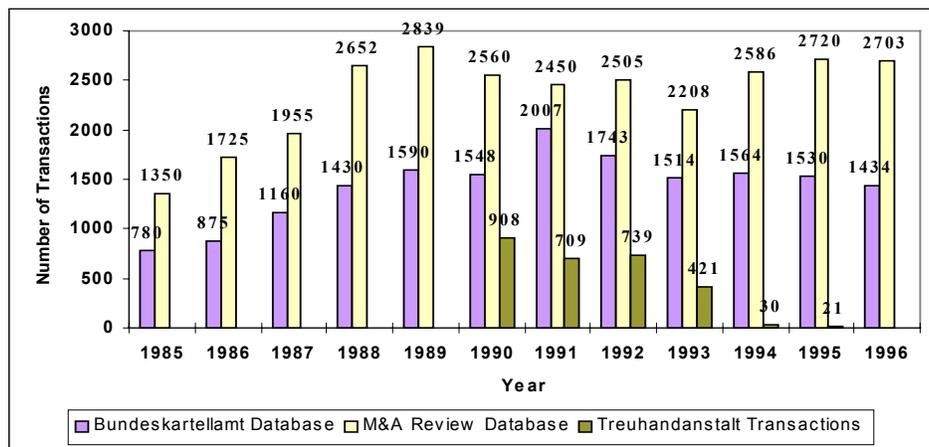
| ASPECTS OF CORPORATE GOVERNANCE | UNITED STATES | GERMANY |
|--|------------------|---------------------------|
| 1. FINANCIAL ASPECTS | | |
| Number of Publicly Listed Firms | Large | Small |
| Universal Banking | No | Yes |
| Concentration of Share Ownership | Low | High |
| Shareholdings of Banks and Insurance Companies | Insignificant | Significant |
| Shareholdings of Mutual Funds | Significant | Small/Growing |
| Shareholdings of Pension Funds | Significant | Non-Existent [§] |
| Shareholdings of Corporations | Lower | High |
| Investor Orientation (Control vs. Portfolio Orientation) | Portfolio | Control |
| Debt/Equity | Low | Low |
| Intermediated Debt/Total Debt | Low | High |
| Role of Internal Financing | High | High |
| Cross Equity Ownership | Low | High |
| Turnover of Large Equity Blocks | High | Low |
| 2. GENERAL LEGAL ASPECTS | | |
| Accounting Law | Shareholder bias | Creditor bias |
| Insider Regulations | Strict | Limited |
| Cross Equity Holdings | Restricted | Unrestricted |
| Exercise of Proxy Votes | Management | Deposit Banks |
| Voting Right Restrictions | Rare | Frequent [§] |
| Management/Board Liability for Misconduct | Very Weak | Weak [§] |
| Auditor Liability for Misconduct | Strict | Very Weak [§] |
| Antitrust Law | Efficiency Bias | Fairness Bias |
| 3. INTERNAL CONTROL MECHANISMS | | |
| Board Structure | Single-Tier | Two-Tier |
| Independent Decision-Making Power of Management | Significant | Large [§] |
| Role of Supervisory Board/Outside Directors | Unimportant | Important |
| Board Representation of Strategic Investors | Rare | Frequent |
| Board Representation of Financial Intermediaries | Rare | Frequent |
| Long-Term Relationship between Banks and Firms | Limited | Extensive |
| Co-determination | Unimportant | Important |
| Value-Based Management Incentive Schemes | Important | Unimportant |
| Investor Relations | Developed | Neglected |
| 4. EXTERNAL CONTROL MECHANISMS | | |
| Frequency of Unfriendly Takeovers | High | Very Low |
| Regional Segmentation of Product Markets | Low | Significant |
| Information Available about Publicly Listed Firms | Extensive | Limited |

Interaction between Intermediaries and Fin. Markets Extensive Limited
Turnover on the Market for Management Labor High Low

§ These aspects and the governance problem implied therein are currently subject to legal reform. See Bundesministerium der Justiz [14]. *Source:* Allen/Gale [1], 203-4; Berglöf [5], 97; Dufey, Hommel, Riemer-Hommel [17]; Fukao [27]; ICMG [36]; Nunnenkamp [41], 3; Prowse [43], 34 and 39.

Figure 1

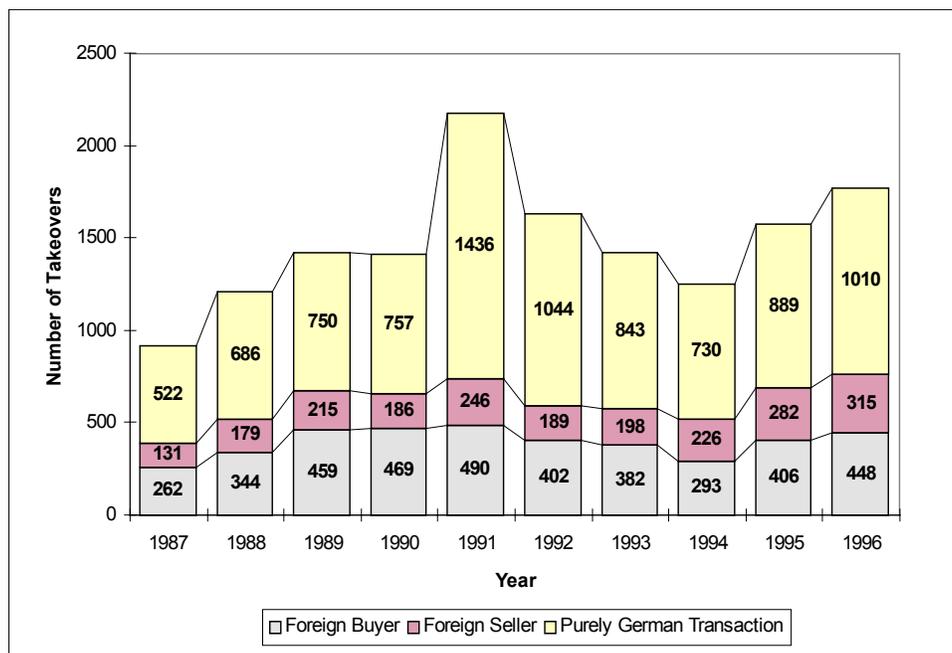
M&A transactions involving sizable equity blocks in Germany, 1985 - 1996[§]



§ The *Bundeskartellamt Database* includes asset deals and share purchases surpassing the 25% and 50% equity threshold, joint ventures and other contractual arrangements leading to direct or indirect control. The joint turnover of the companies involved in the transaction must reach at least DM 500 million. Data collected by the *M&A Review* includes all published transfers of majority control (excluding sell-offs by the *Treuhandanstalt*); publication requires that target firms have an annual turnover of at least DM 20-30 million over this time-span. *Source:* *M&A Review Database (October 1, 1997)*.

The widespread presence of block owners with a long-term investment horizon is considered as one of the main advantages of the German system of corporate governance. Block owners are able to internalize a larger fraction of the gains from direct monitoring and will therefore devote more resources to this activity than small shareholders. Hence, block owners can help to resolve the shareholders' free-rider problem. In addition, stable monitoring relationships work towards creating an environment of trust and cooperation between management and owners and, thus, form the foundation for implicit contracting (Shleifer/Summers [50], 37-41). Monitoring by block owners does not necessarily take place through institutionalized channels in Germany given that the institution "supervisory board" at present suffers from serious defects¹¹ and direct communication with management does not automatically constitute a conflict with the law (Dufey/Hommel [16], 197-8).

Figure 2
Takeovers (majority acquisitions) with German involvement, 1987-1996[§]



[§] Takeover data includes all published transactions (including Treuhandanstalt sell-offs). Non-published takeovers involving small- and medium-sized companies are estimated at 30-40% of the reported figures. Source: Data provided by M&A International GmbH.

Block owners de facto represent the shareholders at large. In order to evaluate the effectiveness of this arrangement, it is necessary to take a closer look at the distribution of share ownership across different investor groups and to analyze the potential presence of agency conflicts. A look at Table 3 illustrates that non-financial companies represent the single most important investor group in Germany. As in France, these equity stakes are often part of cross ownership arrangements which bear the potential of isolating management from outside control.¹² Company investors also display a greater willingness to acquire majority

stakes (see Table 2), mainly because they operate in the same market as the investment target and aim at exploiting cost synergies. Hence, minority shareholders are faced with a potential reallocation of wealth if the majority owner succeeds in manipulating transfer pricing arrangements between the two companies.

Table 2
Block ownership of German industrial and commercial companies (% of sample)

| INVESTOR TYPE | NUMBER OF STAKES | SIZE OF STAKES (IN %) | | | | | | Unknown |
|---------------------------|------------------|-----------------------|------|-------|-------|-------|--------|---------|
| | | 0-5 | 5-15 | 15-25 | 25-50 | 50-75 | 75-100 | |
| Trusts/Institutional Inv. | 54 | 3.7 | 22.2 | 18.5 | 35.2 | 16.7 | 3.7 | 0.0 |
| Banks | 39 | 2.6 | 46.2 | 7.7 | 38.5 | 2.6 | 0.0 | 2.6 |
| Family Groups | 58 | 6.9 | 8.6 | 12.1 | 19.0 | 32.8 | 15.5 | 5.2 |
| Other Companies | 80 | 2.5 | 22.5 | 7.5 | 21.3 | 25.0 | 21.3 | 0.0 |
| State | 4 | 0.0 | 25.0 | 25.0 | 0.0 | 50.0 | 0.0 | 0.0 |
| TOTAL | 235 | 3.8 | 23.0 | 11.5 | 26.4 | 21.7 | 11.9 | 1.7 |

Sample: 171 large industrial and commercial companies quoted in 1990.

Source: Franks/Mayer [22], 285 and 288, own calculations.

Table 3
Distribution of share ownership in selected countries (in %)

| INVESTOR | GERMANY (1993) | U.S.A. (1990) | JAPAN (1990) | FRANCE (1993) | ITALY (1993) | UK (1993) |
|--------------------------|----------------|---------------|--------------|---------------|--------------|-----------|
| Banks | 14.3 | 0.0 | 18.9 | 4.3 | 9.9 | 0.6 |
| Insurance Companies | 7.1 | 4.6 | 19.6 | 2.2 | 0.8 | 17.3 |
| Pension Funds and Others | 7.7 | 25.8 | 9.5 | 1.9 | 0.6 | 43.9 |
| Non-Financial Companies | 38.8 | 14.1 | 24.9 | 54.5 | 23.0 | 3.1 |
| Private Households | 16.6 | 50.2 | 22.4 | 20.7 | 33.9 | 17.7 |
| State | 3.4 | 0.0 | 0.7 | 4.5 | 27.0 | 1.3 |
| Foreign Investors | 12.2 | 5.4 | 4.0 | 11.9 | 4.8 | 16.3 |

Source: OECD [42], 99.

Universal banks hold substantial equity stakes themselves and further increase their control through proxy voting rights and equity holdings of investment fund subsidiaries. Baums/Fraune [2] show that banks have collectively exercised 84.09% of the voting rights of the 24 largest widely held companies in 1992; 34.74% of the votes were controlled by Deutsche Bank, Dresdner Bank and Commerzbank alone. In addition, insurance companies

hold substantial equity stakes in the non-financial sector and have long-standing cross-equity ties with universal banks. Financial intermediaries have the potential to appropriate wealth from minority shareholders. First of all, financial intermediaries exercise control to maximize the return on their equity *portfolios* rather than on individual investments. Coordination between them may be optimal for a sufficiently symmetric distribution of ownership claims (Dufey/Hommel [16], Appendix). Second, value-oriented universal banks have an interest in maximizing the total profit from a client relationship which is, above all, driven by the ability to place financial services, in particular bank loans. We face considerable uncertainty over the financial intermediaries' objective function given that they jointly control a majority of votes at their own general meetings (Baums/Fraune [2], 106) and thereby isolate management from outside influence. A rapidly growing empirical literature has studied the effects of bank influence on corporate performance and has so far not been able to identify the postulated negative effect.¹³

In summary, economic reasoning and circumstantial evidence (e.g. control failures at Daimler-Benz, Bremer Vulkan, Metallgesellschaft and Klöckner-Humboldt-Deutz) stand against weak empirical evidence in arguing that internal control structures in German corporations are problem-laden and the benefits of implicit contracting remain to a certain degree a myth (see also Macey/Miller [40]). The implicit control vacuum can only be filled by a market for corporate control capable of overcoming the structural barriers of concentrated share ownership.

From a corporate governance perspective, internal control deficits in majority-owned firms do not pose a serious problem since the majority stake can always be sold or management replaced. Regulatory authorities may however be concerned with agency costs associated with the representation of shareholder interests by the majority owner. Specifically, if the majority stake exceeds 75% (*qualified majority*), then the aforementioned veto powers of minority shareholders cease to exist. Once the equity stake reaches 90%, minority shareholders also lose their right to hold management and supervisory board liable for misconduct. Finally, companies with a stake of more than 95% (*merger majority*) may be subject to full takeover at the majority owner's discretion. The potential problems associated with these statutory arrangements will be discussed in section IV.

It is safe to argue that non-majority-controlled firms will have, for all practical purposes, at least one shareholder (or coordinated shareholder group) with a "blocking minority". The process of transferring ownership and control rights in German companies naturally reflects this structural feature. Control deficiencies are, first and foremost, dealt with internally through the pooling and redistribution of control rights and, if need be, through the reallocation of equity stakes and voting rights. Extreme forms of managerial failure may lead block owners to acquire majority control or may trigger the transfer of control rights to outsiders via a coordinated placement, not seldomly orchestrated and intermediated by the company's house bank.

Not all transfers of ownership and control rights to outside investors are however "friendly" in nature. Jenkinson/Ljungqvist [37] for instance document a total of 17 cases¹⁴ for the last decade alone where "outside raiders" have attempted to acquire majority control via hostile stake-building.¹⁵ In these instances, investors have built up "toehold stakes" (Shleifer/Vishny [52]) in order to upset the internal control equilibrium and to bring about an

environment conducive to an actual takeover. The raider's success depends critically on cracking the shareholder coalition supporting management which can be done much more effectively from the inside. The process of hostile stake-building has frequently been accompanied by tactics quite common in the U.S. as well: raiders place equity blocks with "friendly" investors to circumvent disclosure requirements (for a discussion see Becht/Böhmer [3]) and to secretly build up a controlling stake; the management of target firms works towards assembling or maintaining their own support coalition among shareholders or invites a "white knight". Voting right restrictions have played an important role in preventing unfriendly takeovers in the past (e.g. *Continental, Feldmühle Nobel*) but are likely to be banned with the passing of a recent legislative proposal (Bundesministerium der Justiz [14]).

Very little evidence points towards hostile stake-building being currently used for the correction of control deficits. Jenkinson/Ljungqvist's [37] painstaking effort shows that unfriendly shifts in ownership structure are rare and have mostly affected firms with no apparent control problems. Given that „raider“ and target firm have, in the overwhelming majority of cases, been horizontally (and in exceptional cases vertically) related, these takeover attempts were therefore much more likely driven by cost synergies, market power considerations or empire building.

The empirical evidence on German takeovers indicates that (a) shareholders of target firms tend to capture positive abnormal returns, (b) abnormal returns for acquiring firms fail to follow a common pattern and (c) certain forms of block ownership foster the value creation process. Early event studies (e.g. Bühner [12]) suffer from misspecifications of the announcement day, non-stationarity problems of the market model parameters and, from today's perspective, non-representative sampling periods (see also Grandjean [31]). Gerke et. al [28] analyze 105 takeovers for the sampling period 1987-92 using news releases for the specification of event dates. Their findings indicate that the average target shareholder has gained from takeovers but that the abnormal returns for acquiring firms did not deviate significantly from zero in the aggregate. Horizontal mergers were perceived as value enhancing while diversification into other lines of business (conglomerate mergers) yielded negative abnormal returns. Böhmer/Löffler [9] use the merger notification dates, as reported by the Federal Antitrust Office (Bundeskartellamt), for their specification of the announcement period and show for a sample of 672 takeovers during 1985-93 that the acquisition of majority ownership has only yielded positive abnormal returns during the up-states of the business cycle. Regarding the effect of block ownership, Böhmer [8] shows for a sample of 297 takeovers and the period 1984-88 that companies with blocking minorities (ownership stakes between 25% and 50%) were most likely to engage in value-increasing takeovers while the acquisition of majority control primarily benefited family-owned firms. In addition, Franks/Mayer [23] find that control changes are more likely to occur after periods of poor corporate performance.

For the purpose of the subsequent discussion, we can conclude that takeovers represent an important and frequently employed instrument to deal with control deficiencies in German companies. The prevalence of block ownership has helped to shape a takeover process quite distinct from the U.S. experience. The empirical evidence is consistent with basic economic intuition: target shareholders gain and bidder shareholders may win or lose

depending on the underlying takeover motive. We have at this point no empirical support for the hypothesis that minority shareholders systematically lose as a result of takeovers.

III. Regulating Takeovers in Germany: The Role of Judicial Hierarchies

German authorities have always applied the principle of self-regulation to takeovers. In 1979, the Exchange Expert Commission (Börsensachverständigenkommission) of the Federal Finance Ministry published general guidelines for public tender offers which attempted to ensure that shareholders are treated equally, receive sufficient information and are subjected to a fair and orderly takeover process. This initial effort to regulate takeovers never achieved any practical relevance, primarily because it left issues concerning the target firm unregulated (e.g. anti-takeover measures) and failed to guarantee a formal process of accession to the guidelines (Schuster/Zschocke [47], 48-50).

With the rising frequency of takeovers after the adoption of the Single European Act (1986), the EU Commission recognized the need for a common legal framework governing tender offers and published a draft directive in 1989 which implemented the principles already embedded in the German takeover guidelines. The statute was never adopted because of a number of controversial aspects, in particular the neutrality requirement for the target firm's management, the obligation to make an offer for all securities outstanding after a shift in majority control as a means of protecting minority shareholders and, lastly, the implied necessity to remove legal obstacles against tender offers by certain Member States (see also Schmidt et. al. [45], 123-4).

In February 1996, the EU Commission finally submitted a revised (and still pending) version of its Takeover Directive which has addressed some of these objections: the management's responsibility for the firm as whole is explicitly mentioned and the requirement to submit a mandatory tender offer is converted into an option for national authorities. Member States have also developed a greater open-mindedness with respect to takeovers in response to growing pressures from international financial markets and, thus, its final adoption is almost certain.

In a parallel effort, the German Exchange Expert Commission has introduced a new Takeover Code in October 1995 which is closely modeled after the British City Code and largely fulfills the provisions of the proposed EU Takeover Directive. It continues to be based on the principle of self-regulation but, unlike the 1979 guidelines, provides for an orderly process of accession which imposes a private contractual obligation upon the signatories. A special Takeover Commission (Übernahmekommission) has been established to administer the Code and to recruit corporate support. Table 4 illustrates that merely a third of all companies contacted have submitted acceptances so far which, if not improving, might eventually give rise to binding federal legislation.

As outlined in Figure 3, the German Takeover Code ensures that all shareholders are treated equally and that all aspects of a takeover offer are made transparent to any party with a direct stake in the outcome. Anti-takeover measures or other manipulative actions affecting the distribution and magnitude of takeover payoffs are specifically prohibited. As the main substantive addition to the 1979 guidelines, the Exchange Expert Commission has added a mandatory offer requirement to protect minority shareholder rights (Figure 4).

Table 4
Corporate Support of the German Takeover Code[§]

| CATEGORIES | SAMPLE | | ACCEPTANCES RECEIVED | |
|-------------------------------------|--------------|--------------|----------------------|---------------|
| | June 9, 1997 | June 9, 1997 | June 9, 1997 | Oct. 20, 1997 |
| Listed Companies | | 683 | 234 | 251 |
| - of those DAX [®] 100 | 100 | | 35 | 37 |
| - of those DAX [®] 30 | 30 | | 24 | 25 |
| Companies with Brokerage Activities | 171 | | 88 | 88 |
| - of those Listed Companies | 33 | | 28 | 28 |
| - Other | | 138 | 60 | 60 |
| M&A Companies | | 30 | 7 | 7 |
| Other Non-Listed Companies | | 137 | 20 | 21 |
| Total | | 988 | 321 | 339 |

[§] DAX[®] 30 (100) = share price index of Germany's 30 (100) most important stocks (as determined by the German stock exchanges' governing body) *Source*: Own calculations based on statistics supplied by the German Takeover Commission.

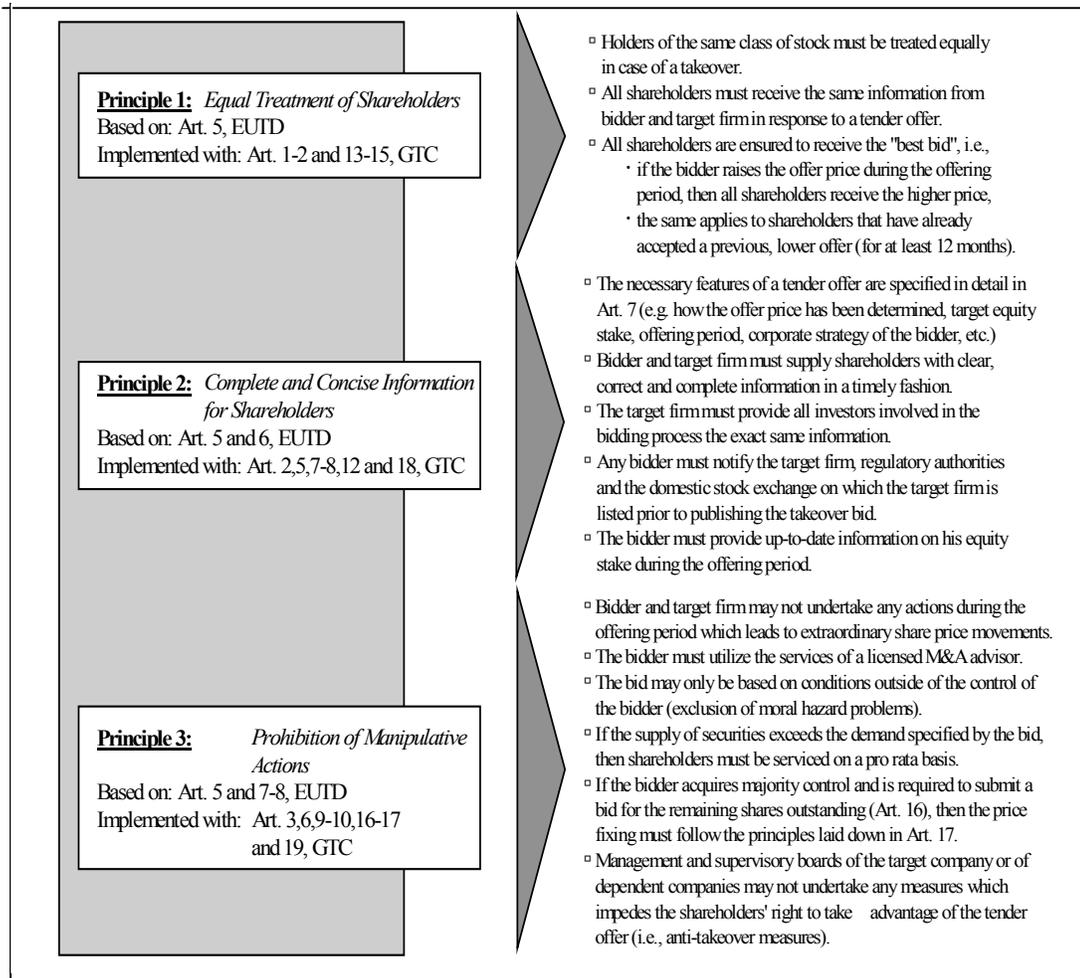
The mandatory offer requirement represents in essence a compound option. Specifically, shareholders collectively hold a long call option written on a set of individually held put options, one for every share of stock. Exercising the call is equivalent to denying the majority owner an exemption from the mandatory offer requirement. As a consequence, every minority shareholder receives a long put option for every share of stock, which entitles her to sell the stock at the subsequently revealed offer price. It is however always optimal for shareholders to exercise the call as long as the majority owner has committed her resources at the time of the vote. In other words, an exemption from minority shareholders should generally not be forthcoming. Section IV further examines the welfare implications of this provision.

The extent to which violations of the Code can be penalized is basically untested ground at this point (Bohne [10]). The Takeover Commission has registered a total of 22 voluntary tender offers between January 1996 and June 1997. Only one firm, a subsidiary of Veba AG, was forced to submit a mandatory tender offer which triggered the purchase of an additional 4.14% of the target firm's outstanding equity.¹⁶ Failing to accede to the Code may be used as a „soft“ (tie-breaking) factor against including a company in one of the German stock market indices. Accepting the Code is also a binding prerequisite for participating in the “Neuer Markt“, Germany's new stock market segment for small-caps. No landmark cases have been decided yet which would give an indication of the potential size of private damage awards.

The regulatory structure currently put in place in Germany can be characterized as a *judicial hierarchy* based on the subsidiarity principle. The proposed EU Takeover Directive aims at harmonizing national takeover regulations without requiring outright convergence, i.e., national statutes must comply with certain basic principles but can otherwise be tailored towards country-specific preferences. Regulatory authority is still vested with the individual Member States who therefore command additional leeway with respect to the enforcement of takeover rules. The European approach stands in direct contrast to the one in the United States where federal and state legislatures are engaged in an ongoing process of *legislative competition* (Hommel/Riemer-Hommel [35]).

Figure 3

Implementation of the (proposed) EU takeover directive^s



§ EUTD = EU Takeover Directive, GTC = German Takeover Code.

Source: Based on Schuster/Zschocke [47], Übernahmekommission [55].

Figure 4
Protection of minority shareholder rights[§]

Principle 4: *Protection of Minority Shareholder Rights*
 Based on: Art. 10, EUTD (left to the discretion of the Member State)
 Implemented with: Art. 16-17 and 23, GTC

If an investor acquires majority control of a corporation (at least 50% of the company's voting stock, including indirectly controlled equity stakes) and no actions are undertaken to integrate bidder and target firm (through an agreement between enterprises, formal merger or de facto integration) within **18 months**, then the majority shareholder must extend a **mandatory tender offer** for all stock outstanding **within an additional 3 months**.

No mandatory offer is required if:

- the 50% threshold has only be exceeded temporarily for the purpose of placing equity with third parties,
- the 50% threshold has been exceeded unintentionally and the problem will be corrected immediately,
- the shareholder meeting exempts the majority owner from making a mandatory tender offer within the 18-month period and the majority owner has committed himself in advance and in writing vis-avis the executive board prior to this resolution not to exercise his voting rights in this matter,
- the German Takeover Commission (Übernahmekommission) grants an exemption (possible if a mandatory tender offer would harm the legitimate interests of the bidder, the target company or the shareholders of the target company).

⇒ The provision only applies to majority ownerships acquired after the date when the company has acceded to the GTC (October 1, 1995 or later).

⇒ Mandatory tender offers are not required for majority stakes already owned by the target firm or the shifting of majority stakes within the same conglomerate.

⇒ Art. 17 regulates the determination of the offer price for **mandatory** tender offers.

§ EUTD = EU Takeover Directive, GTC = German Takeover Code.

Source: Based on Übernahmekommission [55], p. 23-25.

IV. The Economics of Mandatory Tender Offers

The discussion in section II has established that the *scope* of the minority shareholders' control rights is negatively correlated with the size of the majority owner's equity stake. The *ability* to exercise these rights depends in addition on the degree of fragmentation of the minority ownership and the shareholders' ability to overcome the free-rider problem associated with the "production" of interest group pressure (Becker [4]). Mandatory tender offers are intended as a regulatory mechanism to prevent majority owners from infringing on the rights of minority shareholders. The appropriateness of such a measure depends on two conditions to be discussed in this section:

Necessary condition: Minority shareholders are systematically exposed to the expropriation of wealth by the majority owner, i.e., the status quo represents a form of market failure.

Sufficient condition: Mandatory tender offers are the first-best instrument available for correcting the market failure problem.

Satisfying the necessary condition implies that regulatory intervention *can* be in the public interest; satisfying the sufficient condition qualifies mandatory tender offers as a fitting device for preserving the rights of minority shareholders. The subsequent analysis yields a conditional “Yes” in the first instance and an unconditional “No” in the second one.

Corporate takeovers involve real resource costs. Rival bidders and incumbent shareholders have an incentive to free ride on the raider’s information investments and to bargain for a share of the takeover gain, i.e., the raider bears the entire social cost of his activity but can only capture a fraction of the social benefit. Hence, takeovers will typically be underprovided in the free-market equilibrium. The German system of corporate governance has however developed unique ways for the raider to avoid these positive externalities.

As discussed in section II, hostile stake-building permits outside raiders to attain the status of an inside block owner before they are forced to reveal their actual investment motive. Jenkinson/Ljungqvist [37] document numerous cases where raiders were able to secretly assemble a blocking minority through direct share purchases and coalition building with other investors. The implied veto powers of such equity stakes will generally represent a sufficient deterrent to keep other bidders from entering the takeover game, i.e., they represent an entry barrier for outside bidders. Bulow et. al. [13] also show that toeholds may create a winner’s curse problem for outside bidders in auction-type contests: the raider holding a toehold has an incentive to bid more aggressively since his offers simultaneously represent a bid for the remaining shares as well as an ask for his own stake which leads outsiders to bid more conservatively. The positive effect of toehold stakes on the probability of winning a takeover battle and on bidder returns is well-documented in the empirical literature (e.g. Betton/Eckbo [6]). It is however uncertain ex ante whether toeholds increase or decrease the target’s return (Eckbo/Langhor [18], Franks/Harris [26]). German regulators are in the position to limit the downside risk for incumbent shareholders by influencing the degree to which stake-building is made transparent to outsiders. EU regulations¹⁷ nowadays require investors to report their stakes when crossing the 5%, 10%, 25%, 50% and 75% level but German law enforcement authorities hold significant sway over the bidder’s ability to temporarily place stock in the hands of allied investors.

Grossman/Hart [32] argue that companies with dispersed ownership will generally not be subjected to takeovers because free-riding shareholders are unwilling to sell out at a low-enough price. Their proposed solution is to systematically exclude incumbent (minority) shareholders from participating in the value increases brought about by the raider. German corporate law offers ample opportunities for this form of discrimination. Specifically, a three-quarter majority at the general shareholder meeting enables corporate majority owners to impose a control and profit transfer agreement on the firm and its shareholders. Incumbent shareholders are in turn entitled to a cash buy-out offer or the opportunity to exchange their holdings into the majority owner’s stock. Wenger/Heckmann [56] analyze 46 such

agreements¹⁸ between 1983 and 1992 and show that initial offers to minority shareholders had deviated on average by -37.14% from the last stock price; 33 of these agreements would have made minority shareholders worse off with an average value discount of 55.3%. Private litigation has in the past served as an effective corrective mechanism for excessive discounting by the majority owner with nominal increases in the offer value of up to 120%.¹⁹ Thus, it seems that a functioning mechanism with a flexible minimum standard has been put in place in order to limit the minority shareholders' ability to "piggyback" on the raider's efforts.

Art. 17 of the Takeover Code explicitly defines the minimum price to be paid in a mandatory tender offer. If the offer is submitted without undertaking additional share purchases, then the price should not be more than 25% below the weighted average price paid by the majority owner during the 6 months preceding the takeover. If the majority owner has acquired additional shares at higher prices after crossing the 50% threshold, then this price information must be included in the minimum price calculation as well. The sole advantage of this formula-based method is the use of market prices for calculating the value of minority claims. There does however not exist any economic justification for overriding the existing "rule of reason" regulation with a "per se" valuation approach. Further, the specification of the pricing formula itself is completely ad hoc.

Overall, mandatory offer requirements do not seem to tackle obvious regulatory shortcomings which is however not say that they do not exist. More empirical research needs to be done on the long-term impact of takeovers to resolve this issue. Germany's stock market is highly underdeveloped by Anglo-Saxon standards and the accessibility of international financial markets is still limited for corporations other than blue chips. As a result, German companies face significant capital market imperfections that are reflected by the inability to finance all value-enhancing investments with external funds. Mandatory tender offers raise the capital requirements for potential raiders, thereby acting as a takeover deterrent. It has been shown theoretically (Bolton/v. Thadden [11]) as well as empirically (see discussion of Section II) that block ownership leads to better monitoring and control of management which, in turn, implies that adding a mandatory tender offer requirement enhances the residual rights captured by management.

Takeover threats are believed to lead to management myopia and the neglect of investment opportunities with a long-term strategic value. Stein [53] for instance points out that managers have an incentive to engage in (costly) short-term profit boosting as a signal to uninformed shareholders. For our purposes, Schnitzer [46] advances a more relevant point: managers tend to focus on short-term payoffs because implicit contracts will be terminated in case of a takeover. Given that capital market imperfections limit the ability of the investment community to evaluate strategic investments (growth options), managers will underprovide resources for these types of projects.

Thus, if we take such a strictly "Anglo-Saxon" view on takeovers, then the ultimate impact of mandatory offer requirements on corporate competitiveness is uncertain. On the one hand, removing the takeover threat reduces management myopia and strengthens implicit contracting relationships; on the other hand, holding a greater fraction of the residual control rights enhances the manager's ability to shirk. It has however been emphasized throughout the paper that German takeovers are different. In particular, the acquisition of majority

control does typically not lead to the replacement of management (e.g. Kaplan [39]) but rather implies a strengthening of the implicit contracting relationship. By crossing the 50% threshold, the new majority owner enhances her capability to interact with management and signals a long-term commitment to this particular investment. If seen this way, mandatory offer requirements are unambiguously detrimental to the company's long-term health.

V. Conclusions

Both, the U.S. and the German system of corporate governance, are suffering from similar problems but for very different reasons (Dufey et. al. [17], Hommel/Riemer-Hommel [35]). U.S. regulations (e.g. SEC provisions, IRS tax code) create disincentives for investors to accumulate larger equity stakes and to exercise internal control. In contrast, German corporations are often held by one or more block owners with appropriate monitoring incentives but the supervisory board is essentially a defunct institution. The functioning of the U.S. market for corporate control is significantly restricted by the combination of corporate charter amendments and state-based anti-takeover legislation. Germany displays a permissive legal environment with respect to takeovers but preexisting structural barriers (e.g. power of banks, etc.) impede the flourishing of a more active market for corporate control.

Financial market pressures are forcing companies to place a stronger emphasis on value creation and thereby act as a trigger for corporate governance reform in both countries. Overall, Germany finds itself on a promising trajectory towards alleviating its current systemic deficiencies, much more so than the United States. Its Takeover Code opens the doors to the "smoke-filled board rooms" but does yet not fully overcome the tendency to over-regulate and fails to remove the persisting structural impediments.

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NOTES

- 1 "Proposal for a 13th European Parliament and Council Directive on Company Law concerning Takeover Bids" (Official Journal of the EU, No. C 162, June 6,1996).
- 2 Takeover Code of the Exchange Expert Commission at the Federal Ministry of Finance (July 14, 1995).
- 3 See Sherman [49] and Wenger/Hecker [56].
- 4 Implicit contracting refers to an informal understanding between two parties, either based on specific conditions or merely on trust, which is not formally contractable and therefore not enforceable in any court of law.
- 5 A growth option represents an implicit option on the "asset side" of the company's balance sheet (also called "real option"). It grants management the flexibility to take

advantage of subsequently developing investment opportunities. An R&D program may for instance be viewed as an option to later invest in the production and marketing of the R&D output if market conditions turn out to be favorable (see Trigeorgis [54]).

- 6 Financial analysts and portfolio managers have, for instance, only recently begun to demand detailed information on corporate R&D programs: in-depth description of the entire R&D portfolio, investment expenditures per project, the underlying management objective, cash flow estimates, etc. (source: company interviews).
- 7 Böhmer [8] reports for a sample of 297 takeovers and the period 1984-88 that in 75% of these cases the bidder had held less than 25% of the equity prior to the takeover and in 81% of the deals more than 75% of the equity afterwards.
- 8 Recorded transactions in 1988: 534 in Germany, 537 in France and 937 in the United Kingdom (see Jenkinson/Mayer [38], 3).
- 9 Morgan Grenfell (Deutsche Bank), Kleinwort Benson (Dresdner Bank).
- 10 Franks/Mayer [24] report that 85.4% of a sample of 171 industrial and commercial quoted companies had a block owner holding more than 25% of the equity in 1990.
- 11 Key shortcomings are: (1) management board (MB) controls the composition of the supervisory board (SB); (2) chairmen of the SB are often former CEOs; (3) qualification generally not a selection criterion for SB membership; (4) accumulation of SB mandates by individuals; (5) membership of SBs too large (up to 24), triggering free-riding by individual members (e.g. annual reports not carefully reviewed meeting); (6) auditors report to MB (not SB); (7) SB restricts own control competencies voluntarily (via charter amendments) to limit influence of and information dissemination to employee representatives (codetermination). Recent legislative reform proposals (e.g. Bundesministerium der Justiz [14]) will only remedy these problems imperfectly (Hommel [34]).
- 12 Voting rights associated with cross equity ownership may only be exercised in one direction if it exceeds 25% (§328 AktG); this restriction is not able to handle networks of more than two firms. Beyer [7] however tests various network arrangements and does not find any empirical support for the hypothesis that cross ownership affects corporate performance negatively.
- 13 See for instance Cable [15], Elston/Albach [20], Gorton/Schmid [30] and Seger [48].
- 14 Most notably [“Target” vs. “Raider”]: Aachener & Münchener Beteiligungen vs. AGF, Asko vs. Metro, Springer Verlag vs. Burda/Kirch, Buderus vs. Bilfinger & Berger, Continental vs. Pirelli, DBV vs. Zurich Insurance, Hoesch vs. Krupp, Holzmann vs. Hochtief.
- 15 In addition, Schmidt et. al. [45] discuss one hostile tender offer (Postbank AG). Further case discussions are provided by Franks/Mayer [25].
- 16 It is currently discussed to reduce the trigger level for mandatory tender offers to 40% which is typically sufficient for a majority at the general shareholder meeting (Bohne [10]).
- 17 EU Transparency Directive (88/627/EEC); implemented with the Wertpapierhandelsgesetz (August 1994).
- 18 42 companies; 4 companies with common as well as preferred stock; 41 cash offers, 4

- pure stock exchange offers, 1 mixed offer.
- 19 Higher nominal value increases are typically associated with longer litigation periods. Approximate real value increases have been in a range between 0% and 30%.

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