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A SURVEY OF TAKEOVER REGULATION AND PRACTICE IN SERBIA: THE CASE OF MANDATORY PROVISIONS

Introduction

Mergers, acquisitions (M&A) and takeovers as forms of the market of corporate control activity are nowadays the theme of constant discussions and contrasts among professionals and society in general. The economic and managerial literature on M&A and takeovers focuses mainly on the efficiency of M&A (Haley et al. 1992, 1997; Huges 1993, Rau and Vermaelen 1998, Roller et al. 2000, Sudarsanam and Mahate 2003, Schlingemann 2004, Ang and Cheng 2006), the valuation and financing of those transactions (Martin 1996, Linn and Switzer 2001, Eckbo 2008, Martinova and Renneboog 2008, Morellec and Zhdanov 2008), anti-takeover measures (Eckbo 1990, Bhagat et al. 1994, Bradbury and Mak 2000, Stráska and Waller 2010), the takeover tactics and post-deal integration of two business entities. The legal literature on the other side, studies issues like due diligence, representations and warranties as well as legal obstacles, mandatory offers, anti-takeover measures, etc.

In order to create community-wide transparency in the area of takeover bids, foster efficiency and competitiveness of takeover market and prevent distortions done by arbitrary differences in governance within the community, takeover regulation in the European Union has been harmonized since 2004 by enacting the Directive 2004/25/EC. Takeover Directive defines takeover bid terms and procedure, the rights and obligations of the acquiring and target firm (such as the content of the information issued to the shareholder, time allowed for acceptance, disclosure of the

bid) and supervisory authorities in the takeover activities. The regulatory devices available to achieve a well-functioning market for corporate control and protection of the interests of minority shareholders are various. They include the mandatory bid rule, the principle of equal treatment of shareholders, ownership and control transparency, squeeze-out and sell-out rules, the one-share-one-vote principle, the break-through rule, and board neutrality with respect to anti-takeover measures. The adoption of the European Takeover Directive has shifted the interest of takeover studies to these particular devices like the mandatory bid rule, the breakthrough rule, and squeeze-out and sell-out rights.

Takeover regulation is considered to be an important element of corporate governance. Changes in takeover regulation affect the level of investor protection, the development of capital market and the market for corporate control, but they also cause changes in ownership and control (Yarrow 1985, Hirshleifer and Titman 1990, Burkart 1999, Bebchuk and Ferrell 2001, Berglöf and Burkart 2003, Goergen et al. 2005). Reforms of takeover regulation in this way constitute an important channel through which a corporate governance system can progressively develop.

Takeover regulation is an important corporate governance external mechanism, and the attempts to improve its provisions have a significant impact on the wider corporate governance system in the Republic of Serbia. Recent reforms in the field of corporate governance include the reinforced role of stock exchange and security commission in monitoring of companies' governance, as well as the improved regulatory framework, particularly in the field of takeover activity. The mandatory bid rule, principle of equal treatment of shareholders, squeeze-out and sell-out rules, are the regulatory devices in the Serbian takeover regulation available to achieve two main aims – a well-functioning market for corporate control and protection of the interests of minority shareholders.

The aim of the paper is to discuss the rationales and provide an assessment of the application of the mandatory takeover rules and analyze their impact to the takeover efficiency in the Republic of Serbia. Having given an overview of the recent reform of the takeover regulation in the Republic of Serbia in Section 2, we discuss in Section 3 the rationales and objectives of the mandatory bid rule. We analyze its application and point out to its deficiencies at the domestic corporate scene. In Section 4 we explore the objectives of the principle of equal treatment of shareholders in the context of the takeover procedure. Section 5 provides an analysis of the squeeze-out and sell-out rules application at the Serbian market for corporate control and evaluates their economic benefits within the domestic institutional setting. Section 6 concludes.

Reform of takeover regulation in Serbia

Takeover regulation is mainly seen as a mechanism to facilitate efficient corporate restructuring (Burkart 1999), and to mitigate conflicts of interests related to transfers of corporate control. It also impacts the agency problems between management and shareholders, minority and majority investors, and other stakeholders. In this way, it plays an important role in corporate governance system. The shape of the role depends on other characteristics of the governance system such as ownership and control (Goergen and Renneboog 2001, 2003; Goergen et al. 2005). In a system with dispersed ownership, the primary corporate governance role of takeover regulation is to restrain opportunistic managerial behavior. Hostile takeovers target poorly performing firms and replace poorly performing management. Examples of measures stimulating takeover activity are the squeeze-out rule, the break-through rule, and limitations to the use of takeover defense measures.

In a system with concentrated ownership, takeover regulation functions as a corporate governance device aiming at protecting minority shareholders' interests. The concentration of ownership and control is seen as an alternative mechanism that mitigates the conflict of interests between management and shareholders. Although there are a number of standard company law techniques to resolve conflicts between the large shareholder and minority shareholders, takeover regulation plays an important role, as it can provide minority shareholders with an 'exit on fair terms' opportunity. Provisions such as the sell-out right, the mandatory bid rule or the equal treatment principle, ensure such exit opportunities for minority shareholders.

Serbian corporate law in the field of takeover activity has been gradually developed during the last decade. Following the reform of EU takeover legislation, national regulation has increasingly become more detailed and complex. A large part of the law is considered to be mandatory. The activity at the Serbian market for corporate control is regulated by the Law on takeovers, the Company law, The Law on the market of securities and other financial instruments regulation and accompanied directives and rules. The Serbian Takeover law is fully harmonized with the Directive on Takeovers (2004/25/EC) adopted by EU parliament and the Council of the EU in April 2004.

The Law regulates the requirements and procedure for takeover of joint stock companies, the rights and obligations of the participants in the takeover procedure, and the supervision over the implementation of the joint stock company takeover procedure. Before the Law enacting, takeover activity has been regulated by the two system laws (the Company law¹ and the Law of securities and other financial instruments' market²) and the Rules of takeover bid's content and form³. Such a regulation has as a result the Serbian market for corporate control with all the features

¹ "Službeni glasnik RS" 2004, br. 125.

² "Službeni list SRJ" 2002, br. 65; "Službeni glasnik RS" 2003, br. 57; 2004, br. 55.

³ "Službeni glasnik RS" 2003, br. 102; 2004, br. 24; 2004, br. 103; 2004, br. 123.

of the early transition process: accelerated ownership concentration, low corporate governance quality and low protection of minority shareholders.

Serbian takeover regulation is an important corporate governance device, and recent attempts to change its provisions have a significant impact on the wider Serbian corporate governance system. The Serbian Security Commission (SSC) is designated as the competent authority to supervise the application of the new takeover law and the relative directives. This Law is applied to takeover of the joint stock companies with the registered office in the Republic of Serbia, if the shares issued by such companies are traded on a regulated securities market in the Republic. Joint stock companies whose shares have not been traded on the regulated market within the three months preceding the announcement of the takeover bid may not be the subject of the takeover. Under the old takeover regime, the subjects of takeover were also the companies whose shares have not been traded on the regulated market, which were opening the possibility of taking over shares under the price significantly lower than fair (market) value. Consequently, the main function of the takeover mechanism in the corporate governance system had been distorted.

The new legislation of takeover activity effects in a higher level of minority shareholders protection and equal status of all the owners in the acquisition process at the Serbian market for corporate control. The Law introduces provisions relating to sell-out and squeeze-out right, the establishment of an equitable price in mandatory bids as well as creation of adequate "playing field" that guarantees the proper information to all the participants in the bid. The aim of the takeover regulation reforms, was primarily to improve the efficiency of the external monitoring by the market for corporate control, to improve the minority shareholder protection and finally to increase shareholders' (particularly foreign shareholders') confidence and their willingness to invest.

As discussed in previous text, the regulatory devices in the Serbian takeover regulation available to achieve two main aims - a well-functioning market for corporate control and protect the interests of minority shareholders, are the mandatory bid rule, the principle of equal treatment of shareholders, squeeze-out and sell-out rules, and the one-share-one-vote principle. In the following we analyze those provisions in the Serbian takeover regulation and discuss the application of each device as well as its consequences on takeover efficiency and corporate governance in Serbia.

Rationales and objectives of mandatory bid rule

The importance of a mandatory bid rule derives from the fact that it offers the minority shareholders an opportunity to exit the company on fair terms. Since the acquirer may attempt to exploit private benefits of control at the expense of the minority shareholders, the role of the mandatory bid rule is to protect the minority shareholders by providing them with the opportunity to exit at a fair price. The rule

requires the acquirer to make a bid to all the shareholders once a certain percentage of the accumulated shares have been achieved. The mandatory bid rule usually also determines the price of the takeover bid. Depending on the national regulation, the price must not be lower than the highest price paid for the shares already acquired by the bidder or must not be lower than a certain percentage of the average share price of the previous 12 months (e.g. 75%).

Another function of the mandatory bid rule, as Burkart and Panunzi (2003) show, is decreasing the likelihood of value-creating takeovers. The rule makes control transactions more expensive and thereby discourages bidders from making a bid in the first place. Even though, there are several ways to reduce these costs (by increasing the threshold above which the acquirer has to make a mandatory offer, or by allowing the bid price to be lower than the highest price paid for any of the shares previously accumulated), any change to the rule increases the likelihood of the minority shareholders expropriation. Finally, in the of multiple bidder contest, the mandatory bid rule may lower the winning bid price (Bergström et al. 1997, Cornelli and Felli 1998).

The provisions concerning mandatory bids are set out in the Article 6 of the Serbian Takeover law. Article 6 (1) obliges any person who acquires the shares of the target company, and combined with the shares it already holds, has more than 25% of the total number of votes attached to the voting shares of the target company, to make a bid for the outstanding shares of the target company. The acquirer who accumulated more than 25% of the total number of the shares has to inform about this without delay and at the same time the organizational form of the regulated market in which the shares of the target company are traded, the Commission, and the target company.

Under the law, the proposed price in the takeover bid may not be lower than the price at which the acquirer has acquired the voting shares. It can be calculated in two ways: (i) it can not be lower than the average weighted price of shares in the period of three months preceding the announcement of the takeover bid; (ii) If the last market price of shares of the target company on a regulated market on the working day preceding the takeover bid announcement date exceeds the average three-month price, the acquirer is obliged to offer such a price.

What is the application of the mandatory bid rule in Serbia? The Law itself provides the possibility to evade the enforcement of the provisions regarding mandatory bids: (i) when parties to bid are obliged to launch mandatory bid, and (ii) in the price determination process. The most serious deficiency of the mandatory bid rule in the Serbian Takeover law refers to the categories of the rule derogation. Even though the exemptions from the obligation to announce the takeover bid are detailed described (Article 8), the mandatory bid rule is not fully comprehensive, which makes its implementation and its protective function more difficult. Another problem which works against the contribution of the mandatory bid rule is definition of the “concerted parties” (Article 4 and 5). The law provisions about parties

acting in concert should be examined more carefully at the implementation stage, since they give plenty of space for evading the mandatory bid rule.

The principle of equal treatment of shareholders

The principle of equal treatment is established to be one of the most important principles of corporate governance regulation. In the case of takeover regulation, its significance is even higher, since the possibilities of disruptions of the minority shareholders' rights in the control transfers transactions are far-reaching. According to the principle, majority shareholder, the management, and other constituencies are required to treat all shareholders within each individual class of shares equally. The function of the equal treatment principle in takeover regulation is similar to the mandatory bid rule – both of them focus on protecting minority shareholders. More precisely, the equal treatment principle requires an acquirer to offer minority shareholders to exit on terms that are at least as favorable as those offered to the shareholders who already sold their shares. The combination of the mandatory bid and the equal treatment principle increases the costs of an acquisition and decreases the price that a bidder is able to offer to the controlling shareholder (Davies and Hopt 2004).

The principle of equal treatment is declared to be a general principle of the Serbian Takeover Law. According to the Article 2 all shareholders of the target company are equal in the takeover procedure. Minority shareholders may sell their shares to the acquirer under the same conditions as the majority shareholders. The importance of the principle is also underlined in the Serbian Code on corporate governance⁴ (Article 11 to 13).

Squeeze-out and sell-out rights

At the European level the Directive 2004/25/EC requires the EU Member States to provide majority shareholders the squeeze-out right and the minority shareholders the sell-out right in a takeover transaction. The right to squeeze out minority shareholders allows a bidder who has acquired a very large part (90% of voting capital and voting rights in most Member States) of the share capital to acquire the outstanding shares. Forcing minorities out of the company liberates the bidder from costs and risks which the continued existence of minorities could bring. Possibility to squeeze-out makes takeover bids more attractive since full ownership is more valuable to them than a majority ownership. Squeeze-outs can also discourage the free-riding problem and thus enhance the value-increasing takeovers (Yarrow 1985, Burkart and Panunzi 2003). The introduction of squeeze-out regime implies,

⁴ "Službeni glasnik RS" 2006, No. 1.

in the first place, that a takeover can be profitable even in the case the bidder does not own the initial pre-acquisition ownership in the target and does not use the dilution of minority shareholders.

On the other side, provided that the majority shareholder owns 90% (95%) of the equity capital, the remaining minority shareholders have right to require from him to buy out their shares at the fair price (sell-out right). The main argument behind the sell-out right is that it prevents the abuse of the majority shareholder dominant position (blocks the extraction of private benefits at the expense of the minority shareholders). The introduction of the sell-out right is motivated by two types of arguments (European Commission 2002, January). The first type opposes the arguments supporting the application of squeeze-out right. In post-acquisition period the majority owner may abuse his dominant position at the expense of the minority shareholders. In such situations, the market for target firm's shares may become so illiquid to prevent an exit for minority shareholders at a "fair price". According to the second type of arguments, the sell-out right is a way to counter the pressure to tender and to extend the offer period. Shareholders who have rejected the offer initially get, in the post-takeover period, the opportunity to tender their shares once the bidder has gained control and reached the threshold for activating the sell-out right. The sell-out right comforts the shareholder to retain and to reject an offer, especially when the bid price is lower than the pre-takeover share value (in the case of value-decreasing takeover). When the shareholders have a second opportunity to sell their shares, they do not accept offers below the pre-takeover share value. If a takeover succeeds, minority shareholders exercise their sell-out right if the bid price goes beyond the post-takeover share value. Because of that, all value-decreasing takeovers are prevented.

Serbian legislation provides majority shareholders the squeeze-out right and the minority shareholders the sell-out right in the post-takeover period. The Serbian Company Law⁵, which makes the regulatory basis for establishing the relation between shareholder and management structure, incorporates provisions such as squeeze-out right (Article 447) and sell-out right (Article 448). The same field of post-takeover activity is covered by the Article 34 and 34 of the Serbian Law on Takeovers⁶. Unlike the Directive 2004/25/EC on takeover bids, the Serbian squeeze-out regime does not require the squeeze-out to be preceded by a takeover bid. The right to squeeze-out (Law on Takeovers, Article 34) is available to a majority shareholder who acquired at least 95% of shares of a Serbian joint-stock company in a tender offer. In the squeeze-out case, the majority shareholder must compensate the minority shareholders under the terms previously offered in the takeover bid.

The triggering of the squeeze-out right is time limited, within the period of 120 days from the tender offer expiration. The squeeze-out right activation is not related to the majority shareholder's participation in the voting capital and voting

⁵ "Serbian Official Gazette" 2004, No. 125.

⁶ "Serbian Official Gazette" 2006, No. 46.

rights, which is the practice in many EU Member States. This can be explained by the principle of equality of shareholders and the existence of only one class of shares. The analysis of the admissibility of the squeeze-out right application indicates that the legislator determinates quite rigorously the extent of this right. First because of the threshold level (95% of shares of a joint-stock company, i.e. at the upper limit defined by the Directive), and second, since previously realized takeover procedure is a prerequisite for the squeeze-out right application (Dencić-Mihajlov & Malinić 2007).

The sell-out rule is a provision in the Serbian Law on Takeovers aiming at protecting the remaining minority shareholders who have right to demand the controlling shareholder to buy their shares under the terms from the takeover bid (Article 35). The sell-out right can be exercised by minority shareholders via the CSDCH not later than 6 months after the acquisition of at least 95% of shares by the majority shareholder. The sell-out institution in the Serbian takeover legislation indicates the legislator's attitude towards the protection of the minority shareholders' interests.

The enforcement of the squeeze-out and sell-out provisions triggered a wave of squeeze-outs and sell-outs in Serbian companies during the period 2005–2008. Malinić and Dencić-Mihajlov (2008) show in their empirical study that the squeezing-out process, that protects the interests of the majority shareholders, is far more common in Serbian corporate practice than the selling-out process, that is in the function of minority shareholders' protection. This practice, however, rather limits than enhances the flows at the capital market. It diminishes the importance of takeover mechanism as a corporate governance device aiming at protecting minority shareholders' interests.

The squeezing-out and selling-out processes have been significantly intensified following the enforcement of the Law on Takeovers, when 46,07% of successfully ended takeover bids have been completed by triggering squeeze-out or sell-out rights. Malinić and Dencić-Mihajlov (2008) show that 100% ownership over the target company is an important motive behind tender offer announcement and squeeze-out realization at the Serbian market (61,7% of the realized tender offers which resulted in majority ownership of over 95%, majority shareholders used the opportunity to squeeze-out minority shareholders).

In comparison to the realization of squeeze-out right by the majority shareholders, minority shareholders rarely exercise their sell-out right. There are several possible reasons for that: a fair relation between majority and minority shareholders, the quality of securities that minority shareholders does not want to sell, difficult evaluation of the best behavior in a given situation, etc.

Conclusion

Companies require flexibility of the legal framework to optimally implement the goals of chosen growth strategy. Since contracts cannot solve all the conflicting interests of the interests groups in the takeover process, the legislator should provide for an appropriate framework. Takeover regulation and practice in Serbia underwent significant changes at the beginning of this century. Important improvements and changes, especially in the field of mandatory provisions, encompass the following.

The new legislation of takeover activity effects in a higher level of minority shareholders protection and equal status of all the owners at the Serbian market for corporate control. The Law introduces provisions relating to sell-out and squeeze-out right, the establishment of an equitable price in mandatory bids as well as creation of adequate “playing field” that guarantees the proper information to all the participants in the bid.

The importance of mandatory bid rule and the principle of equal treatment of shareholders rests upon their protecting role, since they offer the minority shareholders an opportunity to exit the company on fair terms. However, the effectiveness of mandatory rule has been undermined as the law provides the acquirer the possibilities either to evade the mandatory bid launching process or to deviate from the process of the price determination.

In comparing with the previous takeover regulation, the new Law on Takeovers gives a more flexible framework for the squeeze-out and sell-out right activation and consequently leads to a higher number of squeeze-outs and sell-outs. Both rights are interpreted restrictively and in relation with the tender offer process. Triggering the squeeze-out right appears to be one of the motives for a tender offer even in the situations when the bidder already holds a controlling stock of shares. Even though the activating of sell-out right in Serbian corporate practice is uncommon, the introduction of this rule is very important since it provides a higher level of minority shareholders protection.

Finally, the effectiveness of the takeover mechanism in the Serbian corporate governance system is greatly influenced by the way how proactive and prescriptive an approach the Serbian Security Commission takes.

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