

Our iron takeover law

Why Australia needs a mandatory bid rule

Australia's takeover market is being stifled by unnecessarily rigorous regulation, says ELAINE HUTSON. A mandatory bid rule, at present bogged down by disagreements in parliament, would enhance the efficiency of the market for corporate control.



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The Corporate Law Economic Reform Bill (1998) incorporated two major amendments to the Corporations Law relating to the conduct of corporate takeovers: first, an expanded role for the Takeovers Panel which it is hoped will take the place of the courts in dispute resolution; and, second, the “follow-on” or “mandatory bid” rule, which would allow the purchase of a block shareholding greater than the current 20% takeover threshold, as long as such a purchase is followed by a bid for all remaining shares.

The bill had a rocky passage through the Senate, and was finally passed in October 1999. The mandatory bid rule, however, was blocked by the Labor opposition and referred to the Parliamentary Joint Committee on Corporations and Securities (the PJCS) for further consideration. The opposition's argument was that the rule would disadvantage target shareholders and that the costs outweighed its benefits.¹ These costs would come from “the subversion of good corporate governance principles such as transparency, accountability and equity”.

Although it is not clear how the mandatory bid rule might break these principles, the

opposition appears to believe that because a potential acquirer may be able to gain control of the target before a formal takeover bid, the rule could subvert the spirit of current regulations. In particular, it would:

- discourage competitors emerging in the takeover process — thus inhibiting the “auction” of a target company and lowering the price paid to target shareholders; and
- break the “Eggleston principles” on which Australian takeover regulation is based.

This paper argues that Australian corporate control law needs a mandatory bid rule, and demonstrates that the opposition's objections to the rule are based on spurious claims. Australia's corporate controls are among the most restrictive in the world. A mandatory bid rule would free up the law and bring Australia's corporate control regulation more into line with overseas trends.

IMPORTANCE OF AN EFFICIENT MARKET FOR CORPORATE CONTROL

A well-functioning market for corporate control is essential for the efficiency of industry and commerce and the health of the economy.

There are two routes to adding value through acquisitions. First, one of the most important roles of the market for corporate control is to discipline incompetent or profligate managers, or those not acting in the best interests of shareholders. This is especially important for companies in which there are dispersed shareholdings so that no individual shareholder has sufficient power to discipline or replace inefficient management. For the market for corporate control to operate effectively, takeovers do not actually have to occur in large numbers; the threat of takeover is often sufficient to improve the performance of management. Second, takeovers can be synergistic — that is, two companies may be worth more together than apart. This is an important potential source of value in industries where there are economies of scale, and where declining industries require rationalisation.

Many commentators attribute the success of the US economy during the 1990s to the spate of takeovers and buyouts during the 1970s and 1980s. The so-called “Anglo-Saxon model” of corporate governance, characterised by a reasonably free takeover market that enhances economic efficiency by keeping managers “on their toes” and facilitating rationalisation of industry, has gained the ascendancy. Countries such as Germany and Japan, where corporate combinations have occurred infrequently (and generally as a last resort to stave off company failure), are beginning to appreciate the importance of a well-functioning takeover market to economic health and prosperity.

In Japan, the catalyst has been the prolonged recession of the 1990s and an increasing recognition of the role of mergers and acquisitions in the rationalisation and reallocation of resources that is required to return the economy to health. In Europe, an important catalyst has been increasing European integration, and in particular the European Monetary Union. The European Union (EU) Commission recognises that cross-border mergers and acquisitions are crucial for the establishment of a true single economy, and to that end has been attempting since 1989 to gain agreement on common regulatory standards for the process of mergers and acquisitions.

The EU's current proposed Takeover Directive sets out guidelines for takeover regulation with which each member state must comply. Another important factor in Europe has been pressure from internationalised capital markets for improved shareholder value. This pressure had been lacking in the European business ethos, with its system of cross-shareholdings and limits on voting rights. It is becoming accepted wisdom, however, that firms must exploit all possible synergies to remain competitive in an increasingly integrated economy.

Australia's stringent regulatory regime may be deterring potential bidders from proceeding with acquisition plans because

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the costs of compliance and the low takeover threshold make acquisitions unattractive.² A mandatory bid rule would allow the acquisition of a block shareholding before the bidder incurs the expense of launching a formal takeover bid; thus the rule would go some way to removing an important source of uncertainty for bidders.

THE PURPOSE OF TAKEOVER REGULATION

Takeover regulations were first introduced in Britain, Canada and the US in the 1960s — largely in response to inequities that became apparent during the takeover boom of the early 1960s. In particular, takeovers were conducted with undue haste, giving shareholders insufficient time to consider the offer, and sometimes with opportunities offered to only a few select shareholders. Fairness and the protection of minority shareholders were seen as important; shareholders might be reluctant to invest in equity in markets where minorities are treated unfairly.

The current situation in New Zealand illustrates this point. New Zealand is unique

among OECD countries in that has only very basic statutory rules (dating from 1963) regulating takeovers. The issue has come to the fore recently as the absence of a takeover code is being blamed for low individual investor interest in shares and the depressed New Zealand stockmarket. A survey by investment bank Merrill Lynch, reported in the *New Zealand Herald* on 26 August 1999, showed that international fund managers are reluctant to invest in the New Zealand market because of the possibility of being excluded from participation in premiums paid in takeovers. They also believe that this has contributed to an additional higher risk premium being attached to New Zealand listed companies.

However, many have questioned the need for such rigorous “protection” of target shareholders.³ Target shareholders are the consistent winners in corporate takeovers, earning large excess returns.⁴ Capital markets are highly liquid, allowing investors to vote with their feet and sell their shares when they choose. Well-established risk-management techniques, such as portfolio diversification, reduce shareholders' exposure to the specific risks of individual firms.

It is becoming recognised that takeover regulation must provide a balance between two competing goals: the protection of target shareholders and the enhancement of the efficient functioning of the market for corporate control. This principle is recognised in the British regulations, and by several European countries (in particular France and Germany) which have recently introduced regulatory systems based on the British system. It also receives explicit recognition in the proposed EU directive.

AUSTRALIA'S CORPORATE CONTROL REGULATIONS

Australia's system of takeover regulation imposes extensive shareholder protection provisions on bidding firms. Further, unlike the systems in Britain and most of Europe which balance the requirements of bidding firms with controls on the behaviour of target management, there are few statutory controls on target management in Australia.⁵ Australia's takeover regulatory system is uniquely skewed in favour of the protection of both target management and shareholders, to the detriment of the

efficient operation of the market for corporate control.⁶

Current corporate control regulation is contained in Chapter 6 of the Corporations Law. It includes a blanket prohibition on the acquisition of shares beyond a holding of 20% of voting shares except under the provisions of Chapter 6.

Two allowable methods of acquisition are the takeover scheme ("Part A" bid) and the takeover announcement ("Part C" bid). The Part C bid is a cash-only, on-market, unconditional bid for all voting shares, and it must be open for a minimum of one month. With a Part A bid, consideration can be in the form of cash or shares or a combination of both. It can be a full bid, in which case all shareholders must be offered the same terms; or a proportional partial bid may be made. Offers must be open for a minimum of one month and a maximum of six months, although extensions are possible out to 12 months.

Part A bids are by far the most popular means of acquisition because they give bidders flexibility in financing, and conditions can be imposed by the bidder. (The most common condition is 90% minimum acceptance, because beyond this level the bidder can compulsorily acquire the remaining shares.) Conditions may be waived in the course of the bid, although there are time constraints on the waiving of certain conditions. There are also constraints on the types of conditions that may be imposed; for example, conditions depending on opinions of the bidder, or events that are under the bidder's control, are not permitted.

A third method allowed by Chapter 6 is known as the "creeping takeover", whereby 3% of the voting shares in a company can be acquired in any six-month period.

PARTIAL BIDS

Partial bids are rare in Australia because pro-rata partial bids are disallowed. Before a major amendment to the law in 1986, partial bids were permitted as long as there was pro-rating in cases where the bidder gained acceptances in excess of the required proportion of shareholdings. For example, if the bid was for 40% of voting shares, and acceptances were received for 80%, then

each shareholder may sell only half of his or her shareholding to the bidder.

The current allowable method (section 635(b) of the Corporations Law) for partial acquisition is the proportional partial bid, where the bidder specifies the proportion of each shareholder's holding that it wishes to acquire. For example, if the bid is for 50% of each shareholder's holding, and acceptances are received from shareholders holding 50% of voting shares, then the bidder will only gain control of 25% of shares. This method of acquisition has proved very unpopular because it leaves bidders with a great deal of uncertainty. It would be difficult to know what proportion of the company to bid for. If, for example, the bidder wanted 40%, it may be advisable to bid for a greater proportion than this because not all shareholders would accept.

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But bidders would face the risk of obtaining too many acceptances. It could be difficult to get financing in place under such uncertain circumstances.

THE EGGLESTON PRINCIPLES

The Eggleston principles provide the governing philosophy for Australian takeover regulation. They are all directed at protecting the target shareholder. The principles were enunciated by the Eggleston Committee, which had been convened in the late 1960s to review several areas of company law. The committee's recommendations formed the basis for a major overhaul of takeover regulation in the Uniform Companies Act (1961) (UCA) in 1971.⁷ The principles are:

"We agree with the general principle that if a natural person or corporation wishes to acquire control of a company by making a general offer to acquire all the shares, or a proportion sufficient to enable him to exercise voting control, limitations should

be placed on his freedom of action so far as is necessary to ensure:

- (i) that his identity is known to the shareholders and directors;
- (ii) that the shareholders and directors have a reasonable time in which to consider the proposal;
- (iii) that the offeror is required to give such information as is necessary to enable the shareholders to form a judgement on the merits of the proposal and, in particular, where the offeror offers shares or interests in a corporation, that the kind of information which would ordinarily be provided in a prospectus is furnished to the offeree shareholders;
- (iv) that so far as practicable, each shareholder should have an equal opportunity to participate in the benefits offered."

The first three principles are specifically defined and have been subject to little controversy. In contrast, the fourth Eggleston principle, the equality principle, is vague and is open to many different interpretations.

The equality principle has been subject to considerable criticism for many years. An argument is that it makes corporate takeovers prohibitively costly. This is to the detriment of all shareholders because the market for corporate control is impeded.

THE EQUALITY PRINCIPLE: A MOVEABLE FEAST.

At a Centre for Independent Studies conference on takeovers in 1987, lawyer Robert Baxt made some telling comments about the development of the Eggleston principles:

"A special committee was appointed by the Attorney-General to look at takeovers, and it was given one month, over Christmas, to consider the issue. After one month of marathon sitting the committee came down with four propositions that it suggested were the criteria that should be essential to our takeover code....The one that has caused the most difficulty is the question of equality of opportunity wherever practicable....It seems to me that now is the time when those criteria, which were brought forward after one month of study and no discussion period allowed, should be seriously reviewed" (Baxt 1987, p. 93).

Although the Eggleston principles provided the basis for revisions to the takeover legislation in 1971, it was not until the Companies (Acquisition of Shares) Act (CASA) (1981)⁸ that the principles were specifically written into the legislation. Regulation under the post-Eggleston UCA (1971-80) was much more *laissez-faire* than under CASA, allowing three methods of takeovers which were later seen to conflict with the equality principle.

First, it allowed unregulated on-market bids, whereby a controlling interest in listed companies could be acquired in ordinary trading on the stock exchange. Second, it allowed the unregulated purchase of block shareholders. Beyond the 15% threshold that was in place at the time, up to four individual offers for unlimited quantities of shares within four months were permitted. These two provisions were directed by the Eggleston recommendations (Winsen 1982, p. 98):

“ . . . the committee recommended ‘that an offeror should be free to approach a limited number of shareholders in pursuance of a plan or purpose without having to go through the [takeover] procedure’. The committee also recommended that shares acquired ‘in the normal course of trading on a stock exchange’ should be exempted from takeover regulation.”

Third, it allowed partial bids without a pro-rating requirement. The Eggleston committee recommended against the compulsory pro-rating of partial bids because such a rule “would, we think, involve great difficulties, and we do not see any escape from the position that it is impossible to secure complete equality in this respect” (Eggleston 1969, p. 62).

Following extensive controversy during the 1970s the first two methods of takeover were disallowed in CASA (1981). These methods were seen as inequitable because, in contrast to a formal bid, the offer did not have to be made to all shareholders. CASA also introduced the compulsory pro-rating of partial bids, again as a reaction to a public perception of inequity; partial bids were seen as unfair to minority target shareholders. Proponents of pro-rating argued that under the UCA, only those that accept the takeover offer would

receive the control premium, while others would miss out.

Perceptions of fairness to target shareholders — and thus public interpretation of the equality principle — changed again in the mid-1980s when pro-rata partial bids came to be seen as unfair.⁹ They were seen as giving bidders an unfair advantage by enabling them to acquire control of a company without paying full price. The more serious criticism was that pro-rata partial bids coerced target shareholders into accepting the bid, irrespective of their opinion of its merits. They were said to be faced with the “prisoner’s dilemma”: they did not want to be minority shareholders under the acquiring firm, but did not want to miss out on the premium offered. So they would accept the offer even if they did not agree that the takeover was in the best interests of the target company.

The evidence does not bear out this argument. If partial bids are coercive, a higher success rate among partial bids compared with full bids would be expected. This is not the case. For example, for takeover attempts during 1983 and 1984, the success rate for full bids was 70%, whereas it was only 50% for partial bids (*Business Review Weekly*, 21 March 1986, p. 64).

Many commentators have argued that legislators’ changing perceptions of the equality principle have taken Australian corporate control legislation too far toward the protection of target shareholders (see Winsen 1982, Hannes 1985, Mannolini 1996, and Brown and Da Silva Rosa 1998). Mannolini argues that the principle of equal treatment of target shareholders is in need of urgent review. He argues that there are other safeguards in corporate law to protect shareholders; further, the protection of target shareholders is less necessary because they can use a broad range of risk-reduction strategies such as trading in highly liquid capital markets, portfolio diversification and the use of derivatives. The mandatory bid rule was designed to redress, to some extent, the imbalance that is inherent in the pre-CLERP rules.

Despite the disquiet, however, it seems that the equality principle was not at issue in the Corporate Law Economic Reform Program

(CLERP), according to the policy documents issued by the government in 1997 (CLERP, 1997a and 1997b). The importance of protecting small investors is explicitly recognised in the CLERP policy framework document. One of the CLERP’s six “key principles” is:

“Investor protection: With an increasing number of retail investors participating in the markets for the first time, business regulation should ensure that all investors have reasonable access to information regarding the risks of particular investment opportunities. Regulation should be cognisant of the differences between sophisticated and retail investors in access to information and the ability to analyse it” (CLERP 1997a, p. 3).

REGULATIONS IN OTHER OECD COUNTRIES

Seven OECD countries have been chosen for comparison: Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States. The design characteristics of the systems of takeover regulation in place in these countries can be divided into two types. First, those based on the British system combine a relatively high threshold (30-50%) with mandatory full bids beyond the threshold. In the UK, Ireland, Germany and France, a mandatory full bid is required when a bidder reaches a controlling shareholding. This requirement is also contained in the proposed EU directive. In these jurisdictions, partial bids for control are discouraged. The mandatory bid threshold is specified as 30% in the United Kingdom and Ireland, and 33% in France. In Germany and in the EU directive, the threshold is not defined in percentage of shareholding terms (although there is talk in Germany that the threshold will soon be set at 30%).

Second, those based on the US system combine a relatively low threshold (5-10%) with the allowance of partial bids. The US, Canada and Japan do not have mandatory full bids but pro-rata partial bids for control are permitted. The triggering thresholds for takeover are effectively 5% in the US, 10% or 20% in Canada (depending on whether state or federal law applies) and 5% in Japan.

A second distinguishing feature concerns the relative focus on the behaviour of the bidding

and target firms. In the British model (including France, Germany and the UK) controls on target management behaviour are specified as part of the takeover rules, whereas with the US model (including Australia) the regulations are directed chiefly at the protection of target shareholders, while control of target management behaviour is largely left to the courts.

A third distinguishing feature of the regulatory systems is that some are statutory (Canada, France, Ireland, Japan and the US) while others are self-regulatory (Germany and the UK). The proposed EU directive allows member states to choose their preferred mode of regulation.

AUSTRALIA'S REGULATIONS

Australia's system of corporate control regulation is a hybrid of the US model where a low takeover threshold is combined with allowance for partial bids, and the UK model where there is a higher threshold beyond which full bids are mandatory. It has a low triggering threshold of 20%, but no allowance for pro-rata partial bids. Apart from a full bid, the only means by which a bidder can exceed the 20% threshold is with a proportional partial bid. Australia's regulatory system thus has the lowest threshold of any country where partial bids are discouraged, and arguably is the most restrictive in the world.

THE 'AUCTION' PROCESS

One of the Labor opposition's arguments against the mandatory bid rule is that, by allowing a bidding firm to gain "control" of the firm before making a formal takeover bid, it discourages competition for the target. The concept that corporate control regulation should encourage the "auction" of target companies is a feature of US takeover law, where in certain limited circumstances, target directors are obliged to conduct an auction.

THE ECONOMIC EVIDENCE ON AUCTIONS

The worldwide evidence is generally that takeover premiums are higher when there is an auction (defined as the presence of more than one bidder). For example, Walking and Edmister (1985) found that premiums in the US are on average 33.5% higher when there are competing bids, and similar results were found by Hayn (1989) and Suk

and Sung (1997). In Britain, Franks and Harris (1989) found that announcement-month returns are significantly higher for targets of multiple bids (29.1%) than for targets with only one bid (20.6%).

The evidence in Australia is not as strong as that in the UK and US. In a study examining the premiums¹⁰ for a sample of 616 Australian targets during the period 1985 to 1994, the average premium for multiple-bidder takeovers was 51.5%, compared with 39.9% for single-bidder takeovers.¹¹

The high premiums paid in auctions, however, may come at the expense of bidding firm shareholders. The winning bidder in an auction can experience the "winner's curse" — that is, they pay too much for the target. This will be manifested as negative returns to bidding firm shareholders during the takeover contest. In the US, Morck, Shleifer and Vishny (1990) found that returns to bidders are significantly lower when there are multiple bidders, and that entry by additional bidders reduces the winning bidder's market value by 10 cents on each dollar paid for the target.

Finance theory tells us that in order to minimise risk for a given expected return, investors should hold a diversified portfolio of assets. If the auction process creates the situation where the "winnings" of target firm shareholders are offset by the losses of bidding firm shareholders, shareholders in general are no better off. A regulatory system that promotes auctions of target companies may simply be encouraging bidders to pay too much.

Last, the debate is skewed by the fact that while there is ample evidence of higher premiums in auctions, little scientific evidence exists on the effect of regulation on takeover activity. This is because there is little information about cases where companies have considered an acquisition but declined to act because of the additional costs and uncertainty associated with a probable auction.

CONCLUSIONS

In proposing a mandatory bid rule as part of the CLERP, the government acknowledged what many commentators have been arguing for years — that Australian

corporate control law puts too much emphasis on the protection of target shareholders. Takeover regulation should achieve a balance between this and the promotion of an efficient market for corporate control.

The stringent regulatory regime in Australia has adversely affected the efficiency of the takeover market. A mandatory bid requirement, whereby the acquisition of more than 20% of target shares would be permitted as long as it is followed by a bid for all remaining shares on comparable terms, would go some way to providing more balance in Australian takeover law. By removing an important source of uncertainty for bidders, the mandatory bid rule would facilitate a more efficient market for corporate control.

The opposition's arguments against the mandatory bid rule are that target shareholders would be disadvantaged because such a rule would break the Eggleston principles, and that it would discourage competitors, inhibiting the "auction" of the target company. Since the formulation of the Eggleston principles in 1969, the interpretation of the equality principle has altered from initially being a guiding principle against which other regulatory aims would be balanced, to being the overriding goal of takeover regulation. This is in contrast to other regulatory systems around the world; in particular the British system (which is gaining acceptance across Europe) which explicitly balances the goal of shareholder protection with the enhancement of the efficiency of the market for corporate control.

Research around the world shows that target shareholders earn greater returns when their company is subject to auction. However, this can be to the detriment of bidding firm shareholders. Regulations that encourage the auction of a target company may simply be encouraging bidders to pay too much, with no net benefit to shareholders generally.

NOTES

- 1 These are drawn from Hansard: the CLERB Senate committee hearings 13 October 1999 (Senator Conroy, Victoria) and 20 October 1999 in the House of Representatives (Kelvin Thomson, Wills).

- 2 John Green (Australian Financial Review 10 November 1997).
- 3 In the US the debate has centred on the equity of the “two-tier” offer; see for example Comment and Jarrell (1987). See also Mannolini (1996) for a critique of target shareholder protection provisions.
- 4 For a summary of the international and Australian evidence on this issue see Hutson (1997).
- 5 Target management behaviour is controlled largely by the courts. See Rogers (1994) and Farrer (1997).
- 6 One of the changes to the takeover rules passed by the Senate is a beefing-up of the role of the Takeover Panel, with the aim of reducing litigation as a tactical weapon in takeover battles. If this works as planned, one of the very serious deficiencies in Australian takeover regulation — that it encourages the court challenge as a defence tactic — will be reduced.
- 7 See Hutson (1998) for a more detailed history of takeover regulation in Australia.
- 8 CASA was the forerunner to the current takeover rules. The principles now appear in Chapter 6 of the Corporations Law (1990) (sections 731 and 732).
- 9 The takeover bid for BHP in 1986, in particular, brought the partial takeover issue to public attention. Robert Holmes à Court’s bid for BHP coincided with the proposals to ban pro-rata partials, so he withdrew it and launched a proportional partial bid. In his book about the BHP bid, journalist Gideon Haigh explained the widespread interest in the affair: “In the past, business was the section of the newspaper that lined the nation’s rubbish bins first. It was antediluvian, abstruse and avoidable. But the tremors as BHP locked horns with Robert Holmes à Court (on paper, Australia’s richest man) and John Elliott registered everywhere. Holmes à Court’s puckish expressions stared from the newspaper front pages. Elliott’s rakish, piratical gait became familiar on television. Even the austere manager director of BHP, Brian Loton,

found a niche in prime time. Politicians, analysts, unionists, bankers, company regulators and columnists began to doubt out loud whether it was all worth it” (Haigh 1987, p. 1).

- 10 See Hutson (2000). The premiums were calculated by subtracting the target’s pre-bid share price from the bid price, P_b , and expressing this difference as a percentage of the pre-bid price three months before the announcement ($P_{pre-bid}$):

$$\text{Premium} = \frac{P_b - P_{pre-bid}}{P_{pre-bid}} \times 100$$

- 11 Although this puts multiple bid premiums higher by about one-third on average, this difference is only marginally significant, with a p-value of 0.08 using a standard one-tailed *t*-test.

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