TAKEOVERS AND THE UK ECONOMY

A Reform Agenda

Chris Rees and David Offenbach

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Foreword

The organisational culture of the UK's corporations is in urgent need of change. The prevailing business strategies are driven by short-termism – what Hillary Clinton calls 'quarterly capitalism' based on the delivery of fast-buck profits to shareholders, over and above all other considerations. Addressing this damaging addiction to short-termism will require a new settlement between shareholders, companies and their workforces, and between the public and private sectors. A re-shaping of company law is required, and we also need to re-think company structures so that company directors, managers and the workforces are empowered to think, plan and execute for the long term.

In this important briefing paper, Chris Rees and David Offenbach clearly outline the scope and extent of the challenges that must be tackled, and they also provide a set of compelling and tangible recommendations. They rightly point out that if we are to build a more resilient and productive economy we have to reform the way in which companies are owned and managed. Far too many of the corporations listed on the FTSE 500 are characterised by a transactional, rootless form of ownership which militates against the investment in R&D, innovation, skills development and new technologies which is so desperately needed if we are to re-set and re-balance the British economy.

Chris and David also point to the fact that the prevailing ownership model and mind-set of our corporations is particularly pernicious because it opens the door to takeovers by foreign companies (primarily private equity firms), resulting in the UK having by far the highest number of successful hostile takeover bids of any advanced economy in the world.

Companies do not operate in a vacuum. They are built on an infrastructure that is funded by the taxpayer, and yet in too many cases they have become organisations that exist only to generate short-term profits for their shareholders and exorbitant pay packages for their CEOs. It is time for transformational thinking around the role of business in society, so that business, government and trade unions can become partners for a new kind of growth.

The Labour Party is the party of work and good jobs, and that is why we are the only party that can truly own this agenda and form an alliance with business leaders and trade unions to drive through the necessary reforms once we have returned to government. Chris and David have provided us with a roadmap to re-inventing Britain's corporate culture, and I look forward to taking this conversation to our Party, and to the country.

Stephen Kinnock
Labour MP for Aberavon
Shadow Minister for Asia and the Pacific

Executive Summary

Takeovers are generally seen as an essential element of modern market economies, in that they encourage the efficient allocation of capital and align the performance of managers with the interest of investors. In the UK, however, takeovers do not necessarily work in the best long-term interests of companies, shareholders, or employees. Capital markets have increasingly become a vehicle for value extraction, at the expense of long-term productive investment by companies. Takeovers can be highly leveraged, often making short-term profits but leaving long-term debts. We discuss the causes and consequences of these trends, and outline a series of reform measures.

We start with two observations. First, the current laissez-faire governance regime makes a major contribution to a short-termist business culture, because it opens the door to acquisitions by foreign and UK companies, resulting in the UK having by far the highest number of successful hostile takeover bids of any advanced economy in the world. Second, state support for the current takeover regime means that those who create value and have a long-term stake in firms are excluded from decisions regarding takeovers. This is a consequence of longer-term economic and political trends, including processes of financialization and marketisation. The implications for workers tend to be negative – in terms of the impact on corporate restructuring, jobs and security of employment, as well as employee voice and representation mechanisms.

In light of these problems, we suggest a need for change on two fronts. First, a stronger emphasis on regulating takeovers to promote the national interest (protecting jobs, communities, and R&D). We need tighter controls on takeovers – both for security reasons and also to boost our own economy. Rather than facilitating hostile takeovers, Britain needs a comprehensive industrial strategy and legal/regulatory framework to prevent predatory takeovers and promote our broader national and economic interests. Second, we need to adjust the balance of power in corporate governance and decision-making, empowering employees and managers to have more influence in takeover decisions and, in turn, *dis*empowering shareholders and short-termist financial intermediaries.

In this context, we assess the merits of the new National Security and Investment Act, which comes into force in January 2022. It is to be welcomed that the Act widens the threshold for intervention in takeovers, allowing the government to intervene on national security grounds across a much wider range of companies than at present, and that there will be new penalties and sanctions for non-compliance. However, the Act is deficient in certain other aspects, most obviously in that it represents a missed opportunity to strengthen the UK's wider industrial strategy.

We conclude that a series of changes to the UK corporate governance regime is required to promote workforce voice in company decision-making, strengthen the public interest, and create companies focussed on long-term, sustainable success. After some forty years of neoliberalism, the embrace of globalisation, and finance-led growth, there is now an opportunity for the Labour Party to stake out a radical policy position that places the labour interest and responsible business at its core, and to form a government which can drive a home-grown manufacturing renaissance, underpinned by a democratic, public interest philosophy.

1 Introduction

It is widely argued that any post-covid reconstruction should aim to facilitate a transition to a more resilient and sustainable economy (CommonWealth, 2020; IPPR, 2020; NEF, 2020). The challenge for the Labour Party is to generate a sense of common purpose to win support for a programme of far reaching transformation. As part of this ambition, the Party has launched a new campaign: to make Britain the best place to work. This centres on offering a new deal for working people, based around five principles: security at work, quality jobs, a fairer economy, opportunity for all, and work that pays (Starmer, 2021). Within this, the principles of democracy and voice must be central. Democratic ownership, worker voice, and the public interest should be at the core of a radical economic programme.

We argue for a renewed emphasis on the labour interest and the regulation of work (of which the effective regulation of takeovers is one part). This could be at the heart of a clear Labour vision for a post-pandemic and post-Brexit country (Cruddas, 2021). The objective must be to avoid the negative aspects of unrestrained capitalism whilst encouraging business competitiveness and a more productive economy, based on a renewed partnership of government, businesses, workers, and their trade unions (British Academy, 2019; NEF, 2017; TUC, 2020). The role of government is not to over burden business and stifle innovation, but on the contrary to set the regulatory conditions for competitiveness, democracy, and the public interest to flourish. This paper explores some of the conditions that might apply in the context of corporate takeovers.

The mantra of the current government, post-Brexit, is of a 'global Britain' that is 'open for business'. At the same time this needs to be balanced against the importance of self-reliance and economic sovereignty, tensions which are evident in on-going debates around the regulation of corporate takeovers (Pfeifer, 2021). The Government is currently overhauling takeover law to prevent overseas companies buying up sensitive UK assets, as concern grows about China's influence. Chinese telecoms company Huawei has been banned from Britain's 5G mobile phone networks and ministers are exploring ways to remove China's state owned nuclear energy company from involvement in future UK projects. Concerns that the UK has had too much of an open-door policy in terms of foreign acquisitions lay behind the National Security and Investment Act (NSI Act), which comes into force on 4th January 2022. The new measures will require prospective foreign and domestic buyers of UK companies, shareholdings or intellectual property in seventeen sensitive industries to alert a new government unit about proposed transactions.

There has recently been a flood of acquisitions and proposed acquisitions. Household names that have already been snapped up by private equity since the start of the pandemic include the supermarket group Asda, the roadside assistance company AA, the infrastructure firm John Laing, the insurer LV, defence and aerospace contractor Meggitt, and potentially now Wm Morrison, whose roots stretch back to a 19th-century Yorkshire market stall. The tobacco company Philip Morris is aiming to purchase Vectura, a health firm which makes asthma inhalers! Cheap debt abounds, fuelling a record number of takeover approaches, including that by Cobham – now US private equity owned – for Ultra Electronics (Pfeifer, 2021). Private equity investors from abroad spent nearly £25bn on British firms between the start of 2021 and mid-August, compared with £28bn for the whole of 2020 and £30bn in 2019 (Davies, 2021). According to research by Refinitiv, UK takeover transactions in the first seven months of 2021 reached a fourteen year high, by value, of £142bn. Deals in Germany and France are running at a fraction of this amount. Rather than this buying spree being a sign of confidence in the economy, as ministers claim, this is rather an indication of UK plc being far too easily up for sale.

In this briefing paper we explore some of the issues around the new NSI Act, as well as broader debates around takeover regulation. We build on our Labour Business report on corporate governance reform (Rees and Offenbach, 2020) as well as two recent papers on employee voice and takeovers (Rees and Gold, 2020; Gold and Rees, 2021). We also aim to update some of the arguments and data contained in a previous Labour Business (then LFIG) report (Davis, Offenbach et al., 2013). Our central argument is simple: that the democratisation of takeover decisions – allowing the employee interest and the wider public interest to be better represented and more influential in the takeover process – is one key part of developing more sustainable businesses, which in turn is an essential element of a coherent industrial strategy which can help foster a more resilient and democratic economy.

The evidence on recent takeover transactions shows that the British economy is unbalanced. We need a strong industrial strategy that uses government contracts to support British businesses and prioritise a manufacturing renaissance, so that we buy, make and sell more in Britain. We must make the case for domesticating the economy, for in-sourcing, and for rejuvenating the manufacturing sector alongside a Just Transition to green jobs (Institute for Prosperity, 2021). Whilst Britain should be open to foreign investment, national assets, particularly those of strategic importance, should be protected.

The British economy is also imbalanced in favouring capital over labour. The flaws in our model of capitalism have fuelled a growing divide between the owners of capital and everyone else. For the last three decades annual percentage rises in executive pay for large FTSE companies in the UK have grown at a rate far outstripping those of both company growth and productivity rates, while at the same time real wages have fallen for the majority of low and middle income earners. There has been increasing evidence of a lack of public trust in business, a culture of rising executive pay, short-termism in corporate decision-making, low re-investment, stagnant wages, and poor productivity (CommonWealth, 2020; IPPR, 2018; Johnstone et al., 2019).

Since the 2008 financial crisis, we have seen an intensified critique of the governance of firms, with widespread calls for a more 'responsible capitalism'. More recently, we have witnessed a series of corporate scandals and controversies, including BHS failing in 2016 with a pension fund deficit of £571m, Sports Direct admitting in 2017 to using oppressive workplace practices, Carillion going into liquidation in 2018 after prioritising shareholder dividends over the funding of the pension scheme, and GKN being subject to a hostile takeover in 2018 by a 'financial engineering' firm known for asset stripping and workforce reductions. In terms of the regulation of business there has been growing recognition of the need for a new and more progressive approach to corporate governance (Lawrence, 2017; Talbot, 2016; TUC, 2014; Veldman et al., 2016). A series of reform measures is required to embed democracy and sustainability in the way corporations operate. We outlined a number of possibilities in our recent wide-ranging report (Rees and Offenbach, 2020). We focus on takeovers here.

In terms of takeovers, we make two observations. First, the current laissez-faire governance regime makes a major contribution to a short-termist business culture, because it opens the door to acquisitions by foreign and UK companies, resulting in the UK having by far the highest number of successful hostile takeover bids of any advanced economy in the world. Time after time over the past decade we have seen our strategic national assets being flogged off to the highest bidder. Second, in terms of the takeover process, we argue that those who create value and have a long-term stake in firms are disconnected from decisions regarding takeovers, as a consequence of longer-term economic and political trends (processes of financialization/marketisation and associated state support for a neoliberal takeover regime). The implications for workers tend to be negative – in terms of the impact on corporate restructuring, jobs and security of employment, as well as employee voice and representation mechanisms. We elaborate on both of these issues below.

In light of these problems, we suggest a need for change on two fronts. First, a stronger emphasis on regulating takeovers to promote the national interest (protecting jobs,communities, and R&D). We need tighter controls on takeovers – both for security reasons (given, for example, the growing influence of China) and also to boost our own economy. Rather than facilitating hostile takeovers, Britain needs a comprehensive industrial strategy and legal/regulatory framework to prevent predatory takeovers and promote our broader national and economic interests. Second, we need to adjust the balance of power in corporate governance and decision-making, empowering employees and managers to have more influence in takeover decisions and, in turn, *dis*empowering shareholders and short-termist financial intermediaries. Again we discuss both of these possibilities below.

The implications of this analysis for the Labour Party are clear. The progressive argument for a more inclusive and stakeholder-oriented economy requires a Labour government committed to radical change. At present, the Party appears stuck in debate between the anti-capitalist, statist politics of the left and the pro-globalisation, neoliberal politics of the right. But neither an over-emphasis on the *state* or the *market* will take us forward. Rather, we need to advance a radical policy platform, re-asserting the role of *society*, and of those intermediate-level social institutions that can promote democracy and participation and help rebuild the social fabric. We need a project of national renewal, designed and led by a whole-nation Labour Party. The Party is successful when it offers policies that appeal across both metropolitan professionals as well as those in its traditional heartlands. In the context of Brexit and an increasingly divisive political culture, we believe a renewed focus on the labour interest and on democratising work and business can help consolidate the Party's broad alliance and command a majority in the country.

The next section of the paper outlines some of the problematic features of the UK corporate governance context, commenting specifically on takeovers and the role of private equity, followed by an outline of some possible remedies. We then focus more specifically on recent developments around takeovers and national security, discussing the benefits as well as the shortcomings of the NSI Act. Finally, in the Conclusions section we summarise potential areas of reform and reflect on the implications for Labour Party policy.

2 Corporate governance and takeovers

Over recent decades neoliberalism and financialization have shaped the development of the UK corporate governance regime, which includes the rules and procedures governing takeovers. These trends have also been stimulated by successive governments, insofar as financialization depends on marketisation, in other words, the creation of 'regulatory preconditions' for markets to arise and develop (Callaghan, 2015). Key factors in this process of marketisation have been the globalisation of financial markets and the increasingly autonomous role of both the City and financial intermediaries, which have in turn encouraged the fragmentation of corporate ownership.

This is evidenced in a steep decline in the proportion of UK institutional investors and individual UK-based shareholders and a corresponding increase in foreign investors (to over 50 per cent of UK equities). Individual ownership has shrunk from about 50 per cent in the 1960s to less than 10 per cent today. UK pension funds and insurance companies' ownership of UK listed companies has declined from over 50 per cent in 1990 to less than 15 per cent today, with foreign institutions — such as hedge funds, sovereign wealth funds and overseas pension funds — taking an increasing share (Haldane, 2015; ICSA, 2017).

These patterns have worked to detach shareholders from the companies they invest in. With the share registers of UK companies increasingly globalised, investors have limited jurisdictional commitments and concentrate on speedy financial gains. Strongly embedded incentives for asset holders and corporate executives create powerful tendencies towards short-termism in both finance and industry (Gospel et al., 2014; Jacobs and Mazzucato, 2016). Equity markets have ceased to function effectively as a means of raising new investment and have instead become secondary markets for trading companies as virtual casino chips, encouraging value extraction and transfer rather than value creation, and acting as a barrier to internal, long-term re-investment in human and physical capital, productive capacity, and R&D (CIPD, 2017; Lawrence, 2017; Lazonick, 2016).

Alongside liberalisation and deregulation in capital markets, core institutions of UK corporate governance — takeover regulations, governance codes, and directors' fiduciary duties — are also strongly orientated towards a norm of shareholder primacy. Over recent decades, there has been a growing political acquiescence in these market-enabling rules and an emphasis on 'light touch regulation', centring on deregulation and flexibility as legal and social norms (Rees and Gold, 2020). As Deakin (2018) notes, these rules are justified as making it easier for shareholders to hold managers to account, yet their effect is to tilt the balance of power away from workers and managers, and towards the holders of the capital interest.

All of this means that takeover activity is increasingly driven by short-term profits and financial arbitrage rather than long-term investment and the development of sustainable companies. An active market for corporate control and dispersed share ownership make UK companies more vulnerable to takeovers. Although causal attribution is difficult, companies in the UK and the US, where takeover bids are most frequent, pay out a higher proportion of their earnings in dividends, and a lower proportion in wages, than do companies in countries with less active markets for corporate control (Pendleton, 2016). The absolute number of employees falls in hostile mergers, along with output, and hostile bids tend to induce asset disposals and job losses in the companies targeted, as managers concentrate on creating immediate shareholder value through financial engineering — selling assets, increasing leverage, cutting labour costs, outsourcing work, and casualising the workforce (Johnston and Njoya, 2014).

The City Code on Takeovers and Mergers, administered by the Takeover Panel, is the main repository of rules governing takeovers. Under the Code, the principal duty of the target board is to provide shareholders with advice on the financial value, to them, of the bid, and the board is generally unable to mount a serious defence against it, even if it takes the view in good faith that the bid would destroy firm value over the longer term. Consequently, when takeovers are negotiated, the right to influence the process is the preserve principally of shareholders and financial intermediaries. Management attitudes towards implicit contracts with employees are also informed by the imperative of returning money to investors, which frequently involves work intensification and changes to employee representation (Appelbaum et al., 2013). It is clear that financialization drives corporate level practices, and the pursuit of shareholder value in deregulated and globalising markets has intensified constraints on the strategic choices of firms (Thompson, 2013). There is a direct connection between the pursuit of shareholder value, the behaviour of firm management, and negative impacts on high-performance productivity bargains (Clark, 2009; Cushen and Thompson, 2016). It is difficult to protect human capital investments based on 'mutual gains' and 'partnership', as these are fragile under threat of takeover.

As Davis, Offenbach et al. (2013: 5) concluded in a previous Labour Business report, 'the exclusive focus on 'shareholder value', usually in the short term, has been detrimental to the long-term interests of companies, employees, consumers and the wider economy'. More recently, the final report of the Commission on Economic Justice established by the IPPR likewise concluded: 'Takeovers can drive stronger corporate performance, generating scale efficiencies and reducing operating costs. But it is now widely recognised that many takeovers (particularly large ones) often destroy value, rather than creating it and, in the UK's case, have contributed to long-term industrial decline' (IPPR, 2018: 132).

As well as these detrimental consequences in terms of restructuring and job losses, employees also have few opportunities for meaningful input into takeover decisions. Financialization undermines the organisational capacity of trade unions (Grady and Simms, 2019), whilst the UK corporate governance regime lacks strong voice and representation mechanisms (Gold and Rees, 2021). Not only do company directors in listed firms have no effective way of exercising discretion in favour of resisting hostile takeovers, but labour also has no formal participatory role in decision-making during restructuring. The Takeover Code remains a relatively weak instrument in terms of affording employees meaningful rights to information and consultation (I&C). The Kraft takeover of Cadbury in 2010 and the more recent Melrose takeover of GKN in 2018 illustrate some of the shortcomings in the current regulatory framework (Rees and Gold, 2020). In both cases, the takeover was brought home by votes accruing to the newly acquired shares of hedge funds, and in both cases employees had no effective means of resisting the deal.

This highlights the role of new investor–owners, such as hedge funds, private equity (PE) funds, sovereign wealth funds and associated asset management (Kay, 2015; Mazzucato, 2018). As Clark (2016) explains, these new financial intermediaries generate profits by alterations to the structure of a firm, taking substantial but minority ownership positions in listed firms on an activist basis, either with the aim of launching a hostile takeover or to encourage incumbent management to improve returns to investors via restructuring, divestment, or closure of underperforming units. The resultant financial engineering may improve the short-term profitability of the target company (by selling off assets, reducing staff and cutting investment) but real concerns surround the long-term economic contribution of such activity, particularly as private equity-led buyouts tend to be highly leveraged, with acquisition debts secured on the assets of the target company.

These activities are likely to result in extensive financial and operational restructuring (Pendleton and Gospel, 2014). Capital markets thus increasingly regulate the behaviour of firms, driving down the labour share and legitimising more aggressive management of corporate assets through delayering, downsizing and divestment. Clark's (2016) study shows how pressures to service debt and dividend payments following a private equity takeover of the Automobile Association in 2013 led to 3400 employees being 'managed out of the business', with work intensification for those remaining. More recently, when Advent bought Cobham, the Government asked for commitments, but those pledges didn't prevent the private equity firm from selling off more than half of the Cobham business within 18 months. As a consequence, Cobham now has no UK manufacturing presence.

Another recent case is Morrisons, the UK's fourth-largest supermarket chain, often hailed as a bastion of responsible British capitalism, but now subject to an intense bidding war between investors that have a rather different business ethos. The Competition and Markets Authority (CMA) announced that it had no power to intervene and call in the bids for examination. This is because its regulatory powers relate to competition issues and it cannot consider the wider public interest, or the interests of over 120,000 Morrison employees, or Morrison pension holders in respect of whose welfare their pension trustees have recently expressed concern, or whether the national food supply is sufficiently secure after Covid and Brexit. As we write, Morrisons edges closer to a £7bn takeover by the US private equity group Clayton, Dubilier and Rice.

Cases where PE firms provide the investment or management expertise to help turn companies around or grow are the exception, not the rule. The norm is for PE firms to make extensive use of debt and leverage to seek quick capital gains by financial engineering of the balance sheets of companies, forcing through cost-cutting measures which frequently entail job losses, greater precarity, cuts to pay, and poorer working conditions (Appelbaum et al., 2013). Assets such as land and buildings will be sold, often to an entity registered in an offshore tax haven. The extensive use of leverage not only multiplies returns on investment, but interest paid on debts can also be deducted from tax liabilities. The UK, with its relaxed approach to corporate takeovers, is providing a lucrative hunting ground. Elsewhere in Europe, tighter scrutiny of foreign takeovers and stricter labour laws makes the private equity model less practical (Macfarlane, 2021).

3 Corporate governance reform

The issues raised above call for reform across a number of areas. Financialisation and marketisation are not inevitable processes, but require a particular political/regulatory framework — 'the marketization of corporate control does not take place in a political vacuum' (Callaghan, 2015: 346). As such, we now need to explore the scope for rigorous market-restraining counter-measures. The regulation of takeovers involves a range of legal instruments (such as the EU Takeovers Directive, the 2006 Companies Act and the Takeover Panel's Code), and these have set the context for the role of key actors in the takeover process — shareholders, financial intermediaries, company directors, managers, and employees. Our analysis suggests a requirement for reform across all of these areas, which will necessitate the state providing a coherent form of regulatory overlay.

Principal among these reforms is the need to downgrade shareholder entitlement and challenge the discourse of so-called 'enlightened shareholder value'. As Talbot (2013) argues, shareholders should only have entitlements commensurate with their commitment and responsibility. In law, shareholders are *not* the 'owners' of a company, and due to the principle of limited liability, they have virtually no responsibility for corporate malpractices, and yet still enjoy controlling rights (Ireland, 2018). It is because of the widely held assumption that shareholders *do* own companies that we are led to believe they bear a greater risk than they actually do and are invited to accept as inevitable the negative consequences for workers of MSV strategies (Deakin, 2018). Whilst shareholders can hedge their risks by purchasing a diversified portfolio and, thanks to the liquidity of the market, divest their stock relatively easily at any time, employees with firm-specific skills are unable to hedge, as they will be most unlikely to hold a portfolio of jobs, and they cannot simply trade one job for another (Brown et al., 2019).

Acknowledging this imbalance is at the heart of the argument for the democratization of the company (Ferreras, 2019; Hayden and Bodie, 2020), and there is extensive evidence that democracy at work is key to raising pay, productivity, and innovation (McGaughey, 2021). The reform of voting rights is one way that this imbalance might be redressed. Voting rights in relation to takeovers could be made conditional upon a minimum ownership period, say two years, something the Trades Union Congress has long argued for (TUC, 2014), and voting rights per share could increase with length of ownership. At the same time, there is a need to distinguish between different types of share ownership and investment activity. As Meadway (2020) points out, whilst some financial activities and institutions (hedge funds, for example) are clearly very much driven by short-term gains, others (like pension funds) often look for longer-term, more stable investments that produce steady returns, and these might be the sorts of investment – in renewable power generation, or new public transport, for example – that are urgently needed.

This brings us to the related role of financial intermediaries in takeovers. Our analysis suggests a clear need to reduce the influence of hedge funds and other short-term asset managers. Hedge funds do not operate out of a concern to improve corporate governance, but rather to make short-term gains for the fund. There is a strong case for limiting the right to vote of those whose connection to the company is short-term and opportunistic. Revisions to the Stewardship Code could also be considered. For example, funds that engage in M&A arbitrage could be required to make reference in their Code statements to how (if at all) they engage with the management of companies, what the nature of their interest is (i.e. shares or derivatives, long/short combinations etc.), the typical duration of their interest, and so forth. Private equity owned companies should also be required to publish more information about their finances and corporate structures (Powdrill, 2018). Sectors that provide quasi-public services, such as care homes, could be brought into public ownership to protect them from falling into the hands of predatory capital. Tax reform can also help: removing the tax deductibility of interest payments and taxing 'carried interest' as income rather than a capital gain would significantly undermine the viability of the private equity model (Macfarlane, 2021).

A further obstacle to tackling power imbalances in the regulation of takeovers relates to the duties of company directors, as specified in section 172 of the Companies Act, which defines the 'success of the company' as that which benefits shareholders. Although in law, directors are not simply the 'agents' of shareholders, duty bound to maximise shareholder wealth to the exclusion of other interests (Kay, 2015), directors' skills have nonetheless been honed to increase share prices and dividends in ever more financialized ways, and they do so because these are valued achievements that are rewarded in remuneration and promotion (Talbot, 2013). Reform here would require amending section 172 to make it explicit that the long-term success of a company is (or should be) the primary concern of its directors, and that shareholders' interests, which are increasingly short-term, do not eclipse those of employees as the principal long-term stakeholder in the firm.

Clearly, a further area for progressive reform centres around employee consultation and voice, both prior to and during the takeover process. One key voice mechanism is board-level employee representation. A genuinely representative board, with powers over the takeover process and with duties to promote the wider success of the enterprise, could articulate the interests of those most affected by a proposed takeover, foster longer-term management horizons, and improve the quality of decisions (ICAEW, 2018; Tomorrow's Company, 2016). Following a Green Paper consultation and Select Committee enquiry, in August 2017 the Government invited the Financial Reporting Council (FRC) to revise the Corporate Governance Code to include a new requirement for companies to adopt, on the Code's 'comply or explain' basis, one of three mechanisms for strengthening employee voice: (i) a designated existing non-executive director, (ii) a formal employee advisory council, or (iii) a director from the workforce (BEIS, 2017). These new requirements came into effect in January 2019. A recent FRC-commissioned study suggests that the majority of firms have pursued the NED option and that these reforms have not led to any major improvements or substantial new thinking around board-level workforce engagement (Rees and Briône, 2021). Given these weaknesses, the TUC has long stressed the need for independent worker directors, elected by the workforce and not chosen by management (TUC, 2016; Williamson, 2018).

A second area emerging from our analysis concerns the extent of employee rights within the Takeover Code. Although the Code already includes provisions requiring bidders to explain the long-term commercial justification for an offer and its intentions in a number of areas (including the future business of the target company and repercussions for employees), and undertakings given by bidders are now binding and legally enforceable, the Code remains a relatively weak instrument in terms of affording employees meaningful consultation rights. An opinion appended to an offer document may be taken into account, but it does not have to be considered. A more robust principle would be for the Code to insist upon 'consultation with a view to reaching agreement' before any decision can be finalised. A formal duty to consult could significantly change the takeover process because there would have to be preliminary discussions with the workforce and their representatives.

Third, and relatedly, a strong case can be made for more extensive I&C rights through extending the Transfer of Undertakings (Protection of Employees) (TUPE) regulations. TUPE protects workers' rights where an undertaking is transferred from one employer to another (e.g. in an outsourcing situation) and requires (i) I&C of the employees' representatives, (ii) that T&Cs are transferred to the new employer with no variation, and (iii) that any dismissals due solely to the transfer will automatically be unfair. However, TUPE does not apply to takeovers that take place through a transfer of shares, including private equity buyouts. Extending TUPE protections to takeovers through share transfer could have the effect of distinguishing takeover bids based on plans to extract value from the company from those premised upon a more genuine and long-term economic rationale.

A final area of reform that might provide for greater consideration of the labour interest would be the establishment of a 'takeovers commission', to oversee standards among both listed and private companies (Lawrence, 2017). This could act as an independent regulator with investigative powers and legal remedies for non-compliance, monitoring adherence to section 172 and determining if bids are likely to enhance the target company's economic and productive capacity in the long term. As the IPPR (2018) has argued, such a body could consider the overall rationale for the bid, financial indicators, levels of debt and schedule for repayments, planned investment in R&D and training, and the likely impact on employment and suppliers. This would in effect apply a long-term 'company interest test' to proposed bids, leading to increased disclosure requirements.

Having discussed some broad areas of reform, we now turn specifically to recent developments and the NSI Act. We describe the key aspects of the Act and assess its merits, before finally reflecting on how the Labour Party might take these issues forward.

4 Takeovers, national security and the public interest

4.1 The NSI Act

The power of government to call in a takeover, whether agreed or hostile, for national security reasons, will now be moved from the Enterprise Act 2002 to the National Security and Investment Act 2021, which received royal assent on 29th April 2021. Jurisdiction will move from the Competition and Markets Authority (CMA) to a new unit at the Department of Business, Energy and Industrial Strategy (BEIS) entitled the Investment Security Unit. Whilst certain parts of the new Act will apply retrospectively between 12th November 2020 and 4th January 2022, delaying the whole Act coming into force until January 2022 may allow further unwelcome acquisitions to slip through the net before the more stringent conditions become law.

The premise of the Act is that national security is a public good and market forces do not lead to an optimum allocation of resources. Government intervention is therefore necessary to address this market failure. British officials expect some 1,000-1,830 transactions to be notified under the new takeover regime. It expects to call in a further 75-90 non-notified deals per year. Of this total the Government only expects around 10 deals per year to require 'remedies' (Travers Smith, 2021). Whilst that would represent a sharp increase in scrutiny of transactions, given that there have been only 12 public interest interventions on national security grounds since 2002, the modesty of the Government's ambition for the new NSI Act raises the question of how seriously it wishes to protect the national interest.

At present, under the Enterprise Act 2002, UK authorities can intervene in deals on competition grounds or if a transaction has implications for national security, media plurality, financial stability, or public health (the latter added in 2020, following Covid, by statutory instrument). But this usually only applies if the target asset has an annual turnover of more than £70m or where the merged business would have a market share of more than 25%. Under the new rules, any transaction in seventeen industries will have to be automatically declared to the new Investment Security Unit. The Government insists that foreign investment will continue to drive productivity and create well paid jobs, and the new regulations for screening foreign bids for domestic companies will set clear and efficient ground rules. The process will be similar to the screening carried out in the US, France, Germany and Australia.

The NSI Act will expand the range of circumstances in which a takeover can be called in on national security grounds, and importantly will create a new class of 'notifiable acquisitions' subject to a reporting regime. Where control of a qualifying entity or asset changes hands and the Secretary of State suspects that this may give rise to a risk to national security, the takeover can be called in. The Secretary of State will make a national security assessment (i.e. perform an investigation), on conclusion of which they may make a number of orders. These are broad ranging, and include quasi mandatory or prohibitive injunctions (that something should be done or not done), that a supervisor to the transaction be appointed, or the making of any consequential, supplementary or incidental provision. There is effectively no limit to the contents of the final order, but the most obvious envisaged use would be to block a takeover or acquisition where there is a national security concern. This marks a positive advance from the present position: the Secretary of State is now given carte blanche in investigation and enforcement, creating a tougher regime.

While the Secretary of State can call in takeovers of their own volition, the new class of notifiable acquisitions runs in parallel to this. It introduces percentage thresholds for shareholding and voting rights in entities of national security value. If a change in shareholding or voting rights occurs such that a threshold is crossed, a notification must be made to the Secretary of State. In effect, the call in is made automatically. These threshold limits create a positive new safeguard through ongoing scrutiny of control of entities which may be of strategic importance. These are much wider powers than exist for takeovers with national security issues under the present EA 2002. The voluntary regime is anticipatory, so that a pre-emptive notification may be made. A seller or acquirer may notify the Secretary of State in circumstances where they consider that a trigger event may have taken place. Importantly, if notification is not given and an acquisition is completed without the Secretary of State's approval, the acquisition is automatically void. In practise this means that proposed transactions will be notified to BEIS as the risk of a transaction being declared void *ex post facto* is too great a risk for business certainty.

Importantly, included within the list of intangible assets are such assets as trade secrets, source codes, algorithms, and formulae. This is much wider than the existing regime under the CMA where the Minister can only issue a call in notice in respect of proposed takeovers of public limited companies quoted on the London Stock Exchange. Further, the concept of criminal liability is also introduced for the body corporate itself as well as officers of the company. This is a marked strengthening of the present position, where the only sanction under the existing regime is proceedings for contempt of court for breach of undertaking given at the time of the takeover. Most notably, there is a new offence of completing a notifiable acquisition without approval, punishable with a maximum prison sentence of five years. As to the statutory definition of national security, this is left to the Secretary of State. Following a series of consultations, a statement will be made setting out all the relevant considerations. This will consider sectors of the economy in which trigger events are more likely to give rise to a risk to national security.

4.2 Evaluating the new Act

It is to be welcomed that (i) the NSI Act widens the threshold for intervention, allowing the Government to intervene on national security grounds across a much wider range of companies than at present, and (ii) there will be a new regulatory framework for the imposition of penalties and sanctions for non-compliance. The NSI Act improves upon the previous regime because now, rather than just having post-offer undertakings that are subject only to contempt of court criteria if they are breached, we have a proper statutory framework that will enable the Minister to impose orders meaning that for non-compliance there is a breach of statutory duty, not merely a breach of an undertaking.

However, the Act is deficient in certain other aspects. Most obviously, although it brings the UK into line with other countries in giving itself powers to protect national security, it represents a missed opportunity to do so on wider industrial strategy. It is wrong to suggest that national security, economic security, and industrial strategy can be viewed as discrete issues. National security can only be addressed properly as part of a joined up industrial strategy. There are many examples of priceless assets and world-beating R&D already being lost, particularly in the tech industry: Icera, DeepMind, Arm, GKN, Inmarsat, Cobham Aviation. On a narrow definition of national security, none of these takeovers have been called in.

Two takeovers, in particular, are notable here. First, the proposed £2.6bn acquisition of Ultra Electronics by Cobham, which is owned by the US private equity group Advent International, and second, Nvidia's planned $54bn takeover of British chip designer Arm. The current Business Secretary has announced a formal investigation into the takeover of Ultra, a key supplier to the Royal Navy. The UK has referred the Arm deal for a national security review, and must now decide whether to open an in-depth probe based on both national security and competition concerns. Several commentators – including ADS, the UK aerospace and defence trade body – have questioned whether the PE model, which is typically more short-term than that of an industrial buyer, is the right one for technology that has national security implications (Pfeifer, 2021b).

The response of key Labour Party figures has also been critical. Darren Jones MP, chair of the Business Select Committee, noted that whilst the overarching Government narrative of a greater focus on national security was clear, there was still uncertainty about how this would be put into practice via the NSI Act. Quoted in the FT, he said: 'At the moment, we are operating in a kind of vacuum where there is some legal framework on the books, a huge amount of activity in the market, but no real understanding as to what this set of ministers think, and therefore how they might apply the laws that they put on the books' (Pfeifer, 2021b). Ed Miliband MP, Shadow Business Secretary, raised a similar point during the second reading debate on the NSI Bill: 'It is notable that the Bill brings us into line with other major economies on the security questions we face, but fails to do so on broader issues of public interest and takeovers going beyond national security, despite the clear lessons that have been shown over the last decade' (HoC, 2020). In the same debate, Stephen Kinnock MP, Shadow Minister for Asia and the Pacific, noted that '[The Bill] draws a false distinction between national security and economic security, because it is absolutely clear that the two are intrinsically linked … While we must always seek constructive engagement with China, we must take a clear-sighted, hard-headed approach to defending our national interest and our sovereign capability … This Bill is a big missed opportunity to strengthen the UK's wider industrial strategy and for the Government to show that they are committed to building an economy of purpose and resilience' (HoC, 2020).

The Government needs to be able to intervene in foreign acquisitions that would damage the economy and keep high-growth and strategically important companies in the UK. If a narrow definition of national security is given by the Secretary of State, this will limit the new powers even further. Indeed, the Government has suggested the new powers would only be used 'sparingly'. The Government's own fact sheet states: 'We expect only a small proportion of … assessments to result in government intervention'. The NSI Act therefore falls short without a coherent industrial strategy to safeguard assets such as those listed above.

4.3 Protecting the public interest

A disadvantage of the new regime under the NSI Act is that national security jurisdiction moves to a new internal department at BEIS instead of the CMA (a statutory body, with a requirement for transparency and an established legal basis of operation). The modus operandi of the new national security unit is not yet clear, and neither is the process for public scrutiny. Having lost national security to the new unit, the CMA now only has the ability to make a public interest intervention on three grounds – financial stability, media plurality, and public health. But there are many more areas of public interest, other than these three, and national security at BEIS does not have its own separate statutory body to deal with these issues.

We can also note that the Takeover Panel and the Takeover Code provide no protection of the public interest in a takeover situation, whether hostile or a recommended bid. The objective of the Code is only to protect shareholders and to encourage fair dealing in takeovers. It is not there to protect the public interest, but merely to protect the shareholders who are in receipt of an offer, so that they are given fair treatment.

We would argue that a wider and broader public interest test is therefore needed if government is to protect existing national assets, foster R&D, develop skills, encourage innovation, and develop an effective industrial strategy. Legislation should be introduced to permit intervention by government in takeovers on the following additional grounds:

- where it is necessary in the interests of R&D and innovation;
- where the activity is strategic for the UK economy (as recently introduced in France);
- where it is in the public interest generally. It is important to have a general power such as this because of the ever-changing economic environment and the emergence of new areas of national concern.

One example of a major area which might fall under the definition of public interest is corporate governance. It is self-evident that it is in the public interest for companies operating in the UK to be well governed. Yet there is currently no process in place to allow scrutiny of takeovers of well-run companies by investors or entities who may have little interest in maintaining the same high governance standards. Corporate governance needs to be evaluated within the context of the whole ecosystem within which UK business operates. Economic and national security are intrinsically linked. If a well governed company at the cutting edge of technological development is bought out by foreign investors, asset stripped, and wound up, this is detrimental to both national security, as technological expertise is lost, and economic security, as the entity ceases to exist. In the UK, regulation applies to all UK listed companies whether they are registered in the UK or not. But it does not apply to companies that have no UK listing. To ensure that companies are run according to some minimum standard, corporate governance standards must be part of any future public interest test applied to foreign takeovers.

The Enterprise Act 2002 took previously existing powers to intervene away from ministers and reaffirmed competition as the key reason for referral. It was stated that public interest tests were too vague and barely applied, and that the decision to refer should be 'depoliticised' and made on technical, market-based grounds, rather than political ones. We must now reverse this trend towards narrow competition contexts and re-establish wider public interest criteria in the scrutiny of takeovers. This recognises that it is no longer viable to treat takeover activity as purely a financial market sphere of concern. Takeover activity has profound consequences for the real economy and for national security, which a narrow, competition focus fails to address.

5 Conclusions

Takeovers are generally seen as an essential element of modern market economies, in that they encourage the efficient allocation of capital and ensure good management performance in the interest of investors. In the UK, however, takeovers do not necessarily work in the best long-term interests of companies, shareholders, or employees. As we have discussed, takeover activity may have little to do with the best management of existing assets, the most productive allocation of new capital, or long-term share value.

Capital markets have increasingly become a vehicle for value extraction, at the expense of long-term productive investment by companies. This is evidenced in the increase in share dealings, share buy-backs, corporate restructuring and financial engineering. Despite various government reviews and reform initiatives, the neoliberal, semi-self-regulatory corporate governance framework remains largely unchallenged. Takeovers can be highly leveraged, often making short-term profits but leaving long-term debts. The consequences of these practices for UK industry have been profound: a persistent lack of research investment in equipment and staff training, a bias against smaller public company investment, and a rapidly declining manufacturing sector.

In light of these concerns, we have made the case for a more robust regulatory regime. Far from discouraging investment in the UK, good regulation will encourage long-term and patient capital, and can form part of a range of measures to 'build back better' after Covid and Brexit. Businesses can only do so much on a voluntary basis, and the more enlightened employers also face significant constraints in how far they are able to be progressive in this area. As a result, there is a crucial role for effective state intervention through company law reform.

In this paper and in our previous report, we have discussed a series of proposals aimed at improving the monitoring, transparency, accountability, and effectiveness of corporate power. These focus on changes to the corporate governance regime to promote workforce voice in company decision-making, strengthen the public interest, and create companies focussed on long-term, sustainable success. Specifically in terms of takeovers, we have considered two areas. Firstly, we have suggested various avenues for strengthening the employee voice in takeover processes, including changes to the Takeover Code. Second, we must strengthen our laws against takeovers – not just because it is the right thing to do, but also to encourage long-term UK and overseas inward investors that their investment is safe from short-termism.

The UK has a track record of being the most active nation for takeover activity, and also has the highest success rate for hostile takeovers. If the UK is to remain secure, its industry must be resilient, independent, and at the cutting edge of technological development. Allowing companies to be 'stripped for parts' runs directly against this. This is especially true as the impact of coronavirus is felt, and more and more companies become vulnerable to exploitative takeovers. The NSI Act could be a positive step in terms of national security. However, it represents a missed opportunity to strengthen the UK's wider industrial strategy. We need to focus on home-grown industry, home-grown investment and home-grown technology. This will help to build a sense of purpose, self-reliance and resilience into the UK economy.

As well as making takeovers more productive for the economy, there is a more fundamental need to rebalance the finance-industry relationship. Currently the role of capital markets and financial intermediaries pressures firms towards short-term and dysfunctional business decisions, reducing the scope for re-investment and re-skilling. The corporate governance framework should therefore be re-configured to support responsible business, facilitate the delivery of long-term and sustainable economic growth, and provide an overarching regulatory framework within which good businesses can thrive.

After some forty years of neoliberalism, the embrace of globalisation, and finance-led growth, currently we are in an interregnum, and so a policy limbo. This provides an opportunity for the Labour Party to stake out a radical policy position that places the labour interest and responsible business at its core, and to form a government which can drive a home-grown manufacturing renaissance, underpinned by a democratic, public interest philosophy. The challenge is to re-establish itself as a broad coalition around polices that are in the economic and social interests of the whole nation – to 'rediscover its historic identity as the party of the labour interest, and offer a new model of sustainable and shared economic growth' (Rutherford, 2021: 9). It is entirely open to governments to reform takeover rules and the broader corporate governance regime (Driver and Thompson, 2018). There is nothing inevitable about the current regulatory framework. It is a product of political and economic choices, and these choices can be remade.

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